Supreme Court, U.S.
FILED
FEB 15 1980
MICHAEL RODAK, JR., CLERK

79-1266

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

CHARLES W. STEADMAN,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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February 1980

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner, Charles W. Steadman, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit, reported at 603 F.2d 1126, is reproduced at pages 1-34 of the Appendix. The opinion of the Securities and Exchange Commission is reported unofficially at Fed. Sec. L. Rep. (CCH) ¶ 81,243 (1977).

JURISDICTION

The judgment of the Court of Appeals was entered October 4, 1979. App. 35. Respondent's petition for rehearing, filed October 17, 1979, was denied by the court on November 27, 1979. App. 36. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Whether, in SEC disciplinary proceedings, violations of the anti-fraud provisions of the securities laws must be proved by clear and convincing evidence, rather than by a preponderance of the evidence.

STATUTE INVOLVED

Section 203(f) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(f), provides as follows:

> "The Commission may, after appropriate notice and opportunity for hearing, by order censure any person or bar or suspend for a period not exceeding twelve months any person from being associated with an investment adviser, if the Commission finds that such censure, barring, or suspension is in the public interest and that such person has committed or omitted any act or omission enumerated in paragraph (1), (4), or (5) of subsection (e) of this section, or has been convicted of any offense specified in paragraph (2) of subsection (e) of this section within ten

years of the commencement of the proceedings under this subsection, or is enjoined from any action, conduct, or practice specified in paragraph (3) of subsection (e) of this section. It shall be unlawful for any person as to whom such an order barring or suspending him from being associated with an investment adviser is in effect, willfully to become, or to be, associated with an investment adviser, without the consent of the Commission, and it shall be unlawful for any investment adviser to permit such a person to become, or remain, a person associated with such investment adviser without the consent of the Commission, if such investment adviser knew, or in the exercise of reasonable care should have known of such order."

STATEMENT

Petitioner is president, chairman of the board and owner of all the voting stock of Steadman Security Corporation ("SSC"), an investment adviser registered with the Securities and Exchange Commission. SSC advises and manages several mutual funds known as the Steadman Funds.

The SEC found by a preponderance of the evidence that from 1965 until 1972 Steadman and SSC had borrowed funds from several banks at which some of the Steadman Funds maintained custodial accounts. Using the same standard of proof, the SEC also found that these loans had not been fully revealed to the funds' directors nor mentioned in the

prospectuses. App. 3-5. The Commission did not find that the mutual funds had been harmed by the loans or the banking relationships; on the contrary, the evidence showed that the funds had benefited from the location of the custodial accounts. Moreover, the Commission specifically refused to find that the banks had granted the loans as a quid pro quo for the mutual fund accounts, or that SSC or Steadman had compromised the funds' interests in managing the accounts. App. 6.

Nevertheless, the Commission held that the existence of the loan "relationships" was material information that SSC had a duty to reveal and that petitioner had aided and abetted SSC in violating Section 17(a) of the Securities Act of 1933 ("Section 17(a)"), Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)"), and Subsections (1) and (2) of Section 206 of the Investment Advisers Act of 1940. On the basis of these and other minor violations[1] the Commission (1) permanently barred petitioner from associating with any investment adviser, (2) prohibited petitioner from affiliating with any registered investment company, and (3) suspended petitioner for one year from associating with any broker or dealer in securities.[2] This order, causing the total and permanent disqualification of petitioner

[1] The Commission also found by a preponderance of the evidence that petitioner had violated the securities laws by aiding and abetting (a) SSC's collection of advisory fees in excess of those specified in the management contract, (b) SSC's subsidiary's collection of tender solicitation fees to which it was not entitled, and (c) SSC's failure to comply with certain reporting provisions. App. 2 n.1.

[2] No sanctions were ordered against SSC or its subsidiaries; they did not join in the petition below.

from the investment industry and forced divestiture of his interest in SSC, constitutes the most serious sanction that the Commission could have imposed. App. 28-34.

Although petitioner argued below that the SEC was required to prove the alleged violations by clear and convincing evidence, the United States Court of Appeals for the Fifth Circuit affirmed the SEC as to standard of proof, holding that the violations require proof only by a preponderance of the evidence. Noting, however, that the Commission had imposed the most serious sanctions at its disposal—total and permanent exclusion of petitioner from the investment advisory industry—the Court remanded with directions that the Commission "articulate a sufficient justification" for ordering petitioner's expulsion from the industry. App. 30.

The SEC's petition for rehearing was denied by the court on November 27, 1979. App. 36.

THE QUESTION PRESENTED INVOLVES A CONFLICT AMONG THE COURTS OF APPEALS

Petitioner argued below that in a disciplinary proceeding the SEC must prove violations of the anti-fraud provisions of the securities laws by clear and convincing evidence. The court ruled against petitioner, holding that proof by a mere preponderance of the evidence was sufficient. This holding is squarely and irreconcilably in conflict with the decisions of the Court of Appeals for the District of

Columbia Circuit in *Collins Securities Corp.* v. *Securities & Exchange Commission*, 562 F.2d 820 (D.C. Cir. 1977), and *Whitney* v. *Securities & Exchange Commission*, 604 F.2d 676 (D.C. Cir. 1979).

Like this case, *Collins* involved an SEC disciplinary proceeding. Applying the preponderance of the evidence standard of proof, the SEC found violations of the anti-fraud provisions of the securities laws, including Sections 10(b) and 17(a). *See* 562 F. 2d at 821. The court of appeals unanimously reversed, holding that the more stringent clear and convincing standard of proof was required in a disciplinary proceeding involving allegations of fraud and the potential of serious sanctions.

The *Collins* court recognized that the preponderance of the evidence standard is normally used in administrative proceedings. Nevertheless, it held that two elements typical of SEC disciplinary proceedings require application of a higher standard of proof: "(1) the type of case (fraud); (2) the heavy sanction (deprivation of livelihood)." 562 F.2d at 824. Analogizing SEC disciplinary proceedings to those for disbarment or suspension of attorneys, the court ruled that serious sanctions for fraud could be predicated only upon clear and convincing evidence:

> "Given those elements, typical of many SEC cases, and given the type of circumstantial proof on which the SEC most often must rely, it appears to us that the 'clear and convincing evidence' standard is the proper standard here; it will require the SEC to reach a degree of persuasion much higher than 'mere preponderance of the evidence' . . . ." 562 F.2d at 824.

The Fifth Circuit rejected the *Collins* approach, holding that the preponderance of the evidence standard was sufficient. The court remanded, however, directing the SEC to articulate its reasons for imposing upon petitioner the ultimate sanction of total and permanent expulsion from the profession.

This approach cannot be squared with that taken by the D.C. Circuit. Under *Collins* no expulsion or lengthy suspension may be imposed, regardless of justification, unless the violation is proved by clear and convincing evidence. Thus, in *Whitney* v. *Securities & Exchange Commission*, 604 F.2d 676 (D.C. Cir. 1979), the D.C. Circuit, reaffirming *Collins*, held that a nine-month suspension by the SEC was sufficiently serious to require proof by clear and convincing evidence. 604 F.2d at 680-81. In contrast, the court below approved the imposition of the most severe sanctions available to the SEC, including total and permanent professional disqualification and forced divestiture, based on a mere preponderance of the evidence.

The Fifth Circuit premised its rejection of *Collins* on the fact that the SEC can impose disciplinary sanctions less severe than permanent debarment. *See* 15 U.S.C. § 80b-3(f). Explicitly mentioning suspension for twelve months, the court argued that these milder sanctions would be appropriate for those whose violations had been proved by a mere preponderance of the evidence. App. 26. This rationale is at war with the approach taken by the D.C. Circuit which, in *Whitney*, held that even a *nine*-month

suspension is a sufficiently serious sanction to require proof by clear and convincing evidence.[3]

The court below also rejected the second basis for the *Collins* opinion. The D.C. Circuit had reasoned that because fraud must generally be established by circumstantial evidence, clear and convincing proof is required to safeguard against an erroneous determination. 562 F.2d at 824-25 & n.32. This Court recently confirmed that the clear and convincing standard of proof is appropriate in proceedings involving allegations of fraud because a finding of fraud tarnishes the reputation of the accused:

> "One typical use of the [clear and convincing] standard is in civil cases involving allegations of fraud or some other quasi-criminal wrongdoing by the defendant. The interests at stake in those cases are deemed to be more substantial than mere loss of money and some jurisdictions accordingly reduce the risk to the defendant of having his reputation tarnished erroneously by increasing the plaintiff's burden of proof." *Addington* v. *Texas*, 441 U.S. 418, 424 (1979).

Reaffirming this aspect of *Collins*, the D.C. Circuit in *Whitney* placed specific reliance upon this passage from this Court's opinion in *Addington*. 604 F.2d at 680 n.14.

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[3] The approach of the court below is also inconsistent with the rule, adopted by many courts, that the standard of proof in a disciplinary proceeding must be more stringent than the minimal preponderance of the evidence standard. *See, e.g.*, In re Fisher, 179 F.2d 361, 369-70 (7th Cir.), *cert. denied*, 340 U.S. 825 (1950); In re Ryder, 263 F. Supp. 360, 361 (E.D. Va.), *aff'd*, 381 F.2d 713 (4th Cir. 1967).

The fundamental conflict between the court below and the D.C. Circuit cannot be disputed. *Collins* and *Whitney* prohibit the SEC from imposing *any* serious sanctions, regardless of justification, unless the violation is proved by clear and convincing evidence.[4] The court below refused to follow *Collins* and squarely approved the weaker preponderance of the evidence standard, requiring only that the SEC give an explanation whenever it chooses to impose the most serious sanction. It is thus certain that the outcome of any review of an SEC disciplinary order imposing serious sanctions will depend upon whether it is brought in the Fifth or the District of Columbia Circuit. This will defeat the Congressional mandate that SEC respondents have the choice of their home Circuit in addition to the D.C. Circuit for review of SEC disciplinary orders. *See, e.g.*, 15 U.S.C. § 77i, 78y.

The conflict between the circuits cannot be reconciled. The cases give inconsistent directives on the proper standard for adjudication, a fundamental aspect of the administrative process. Because a large portion of SEC disciplinary proceedings involve alleged violations of the anti-fraud provisions, the question presented by this petition is crucial to the orderly administration of the securities laws and must be resolved quickly.

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[4] Subsequent to the Fifth Circuit's decision in this case, the vitality of *Collins* was reaffirmed by the D.C. Circuit. Placing specific reliance upon *Collins*, the court held the requirement of clear and convincing proof applicable in Federal Communications Commission hearings involving the possibility of serious sanctions. Sea Island Broadcasting Corp. v. Federal Communications Commission, No. 76-1735 (D.C. Cir., Jan. 14, 1980), slip op. at 6-10.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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February 1980

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT.

No. 77-2415.

CHARLES W. STEADMAN,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

Oct. 4, 1979.

On Petition For Review of an Order of the Securities and Exchange Commission.

Before WISDOM, GODBOLD and TJOFLAT, Circuit Judges.

TJOFLAT, Circuit Judge:

The petitioner in this case, Charles W. Steadman, is the president, chairman of the board, and sole beneficial owner of all the voting stock in Steadman Security Corporation (SSC), an investment adviser registered with the Securities and Exchange Commission (SEC or the Commission). SSC, either directly or through wholly-owned subsidiaries, is the adviser to and manager of several mutual funds known collectively as the Steadman Funds. Steadman petitions for review of the SEC's decision of June 29, 1977, *In re Steadman Security Corp.*, ____ S.E.C. ____, [1977-1978 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 81,243 (1977), which found Steadman, SSC, and the

subsidiaries in violation of several provisions of the securities laws.[1] Because of these violations, the Commission entered an order that would (1) bar Steadman permanently from associating with any investment adviser,

[1] The Commission found the following violations:

1. Steadman, SSC, and SSC's wholly-owned broker-dealer subsidiary, Republic Securities Corp. (RSC), violated or aided and abetted violations of section 17(a) of the Securities Act of 1933 (Securities Act), section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and rule 10b-5 thereunder, and sections 206(1) and (2) of the Investment Advisers Act of 1940 (IAA) by failing to disclose that Steadman and SSC had borrowed money from the banks that maintained the custodian accounts for the Steadman Funds;

2. Steadman and SSC violated or aided and abetted violations of sections 20(a), 30, and 34 of the Investment Company Act of 1940 (ICA) by failing to disclose the bank loans in proxy solicitation materials and annual and quarterly reports;

3. Steadman and SSC violated or aided and abetted violations of section 17(a) of the Securities Act, section 10(b) of the Exchange Act, and rule 10b-5 thereunder, sections 206(1) and (2) of the IAA, and subsection 15(a)(1) of the ICA by failing to disclose that SSC had received compensation from the mutual funds not precisely described in its management contracts;

4. Steadman and RSC violated or aided and abetted violations of section 17(e) of the ICA by receiving tender solicitation fees in connection with the tender of shares held by the funds and not remitting the fees to the funds;

5. Steadman, SSC, and its subsidiaries violated and aided and abetted violations of sections 30(a) of the ICA and rules 30a-1 and 30a-2 thereunder, and section 17(a) of the Exchange Act and rule 17a-5 thereunder by failing to file annual reports of three mutual funds and four brokerage firms on time; and

6. Steadman and SSC aided and abetted technical violations of section 17(a) of the ICA by causing one fund under their control to buy and sell securities directly from other funds to which SSC was the adviser.

(2) prohibit his affiliation with any registered investment company, and (3) suspend him for one year from associating with any broker or dealer. No sanctions were ordered against the corporate respondents, and they do not join in this appeal. Steadman raises several points of error in his petition, most of which we find to be without merit. We grant the petition in part, however, and remand the case to the Commission for reconsideration of the sanctions.

The violations found by the Commission relate to several different aspects of Steadman's management of the mutual funds through the corporations he controlled. See note 1 *supra*. The violations we shall discuss concern Steadman and SSC's loan relationships with the banks used by the funds, the method of repayment to the funds of advisory fee overcharges, the retention by a broker-dealer subsidiary of tender solicitation fees paid for the tender of shares held by the funds, and the failure of Steadman and SSC to file timely reports with the Commission. We shall also examine the burden of proof to be applied in SEC disciplinary proceedings and the factual showing necessary to support the harsh sanctions in this case. As we review each of these areas, the relevant facts will be presented.

I. The Banking Relationships

Between 1965 and 1968, Steadman and SSC borrowed substantial amounts of money from the Riggs Bank of Washington, D.C.,[2] the same bank where the Steadman

[2] The Commission's opinion does not specify any of the banks involved in these dealings, but the Administrative Law Judge's Initial Decision identifies them and their names are not in dispute.

Funds kept their checking accounts.[3] In 1968, SSC began an expansion program to acquire the management rights to additional mutual funds. To finance these acquisitions, SSC applied to the Riggs Bank for a $2 million unsecured loan. The bank turned down the request, finding that the additional debt load on SSC, whose operations had not been profitable, would be too large. Steadman then retained two prominent investment bankers to aid his quest for capital; one of them successfully arranged a $3 million loan to SSC from the Chase Manhattan Bank in New York.

At about the time the Chase loan was negotiated, Steadman and SSC recommended to the directors of several of the mutual funds that the funds transfer their bank accounts to Chase. The directors were told that the New York bank's custodial fees were lower, that it would be advantageous to be closer to the New York securities market, and that there had been problems with the Riggs Bank. They were not told about the loan to SSC. The transfer of accounts was approved.

Riggs called its personal loans to Steadman when the accounts were transferred (SSC had no loans outstanding from this bank at the time). Steadman obtained a collateralized loan from the First National Bank of Washington to repay the Riggs loans. The First National loan was called in 1970 when the value of the collateral declined, but Steadman received a 90-day extension. Two days later, one of the funds purchased a 90-day certificate of deposit from First National in an amount in excess of

[3] The Riggs Bank was the custodian for the securities and other investments owned by the funds and it also kept the fund's cash assets on deposit. Cash assets of a fund include proceeds from the sale of portfolio securities and any judgments realized by the fund. Checking accounts are used by the funds principally to pay dividend distributions and redemptions to fund shareholders.

the loan. To repay his First National loan, Steadman obtained a loan from yet another bank, the National Bank of Washington. Soon afterwards, the custodial accounts for one of the Steadman funds were transferred from St. Louis to the National Bank. The fund's directors were not told about the loan to Steadman when they approved the transfer.

Neither Steadman's nor SSC's loans were disclosed in the mutual funds' prospectuses. The Commission found that this was material information that Steadman had a duty to reveal. His failure to do so was in willful violation of section 17(a) of the Securities Act of 1933 (Securities Act), 15 U.S.C. § 77q(a) (1976), section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78j(b) (1976), rule 10b-5, 17 C.F.R. § 240.10b-5 (1978), and sections 206(1) and (2) of the Investment Advisers Act of 1940 (IAA), 15 U.S.C. § 80b-6(1), (2) (1976). Steadman contends that the Commission erred in finding the omitted information material, and that even if it were material, he cannot be held in violation of these statutes absent a finding that he acted with scienter, *i.e.*, an intent to deceive or defraud.

A. *Materiality*

Steadman agrees that *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976), defines the applicable standard of materiality but argues that the Commission misapplied that standard in this case. The *TSC* case states: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding [the matter before him]" *Id.* at 449, 96 S.Ct. at 2132. The Commission concluded that Steadman's practice of borrowing heavily, for himself and SSC, from the same banks where the funds had accounts created a potential for subordinating the funds' interests to his own. Deposits

are the source of money that banks lend out for interest. Steadman needed large loans. His self-interest in currying the good favor of the banks might have led him, the Commission speculated, to keep unduly large amounts idle in the funds' non-interest-bearing accounts to the benefit of the banks but the detriment of the funds' shareholders. The SEC made no finding that this had in fact occurred and specifically declined to find that the funds' custodial accounts were a quid pro quo for the loans. Regardless of whether there was a connection between the loans and the accounts, the Commission decided that "Steadman had disabled himself from looking at the funds' checking account balances in a wholly disinterested way, with an eye single to the funds' best interest. Investors had a right to know this." ____ S.E.C. at ____, [1977-1978 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 81,243, at 88,339-7 (footnote omitted). Therefore, the loans were material under the TSC standard. *Id.* at ____, [1977-1978 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 81,243, at 88,339-9.

Steadman argues that the SEC found only a *potential* conflict of interest, and *TSC* requires an actual conflict before liability may be imposed. This misreads *TSC*. The relevant part of the *TSC* opinion involved the nondisclosure of facts that may have indicated possible market manipulation in the context of a proxy solicitation, a completely different context than what is involved here. More importantly, the Court was addressing the sufficiency of the plaintiff's case for summary judgment, *i.e.*, whether the omission was material as a matter of law. The Court was not called upon to decide the quantum of evidence necessary to establish a material omission at trial. The Court reaffirmed in *TSC* that the issue of materiality is a mixed question of law and fact and that divining the significance of the inferences a reasonable investor would draw from a given set of facts is peculiarly

within the competence of the trier of fact. Turning again to the facts of the case before it, the Court said that facts suggesting that one corporation controls another may be material even though in actuality there is no control; the influence of the one company over the affairs of the other would be of importance to shareholders. 426 U.S. at 453 & n.15, 96 S.Ct. at 2134-35. Here, the Commission is the trier of fact. It decided that, under the circumstances of this case, the potential for Steadman's abuse of his influence over where the funds did their banking was sufficiently great that shareholders would want to know about the loans. That finding is not wrong as a matter of law, and we affirm it.[4]

B. *Scienter*

Steadman strenuously urges that scienter—an intent to deceive, manipulate, or defraud—is a necessary element of any enforcement action by the SEC under the anti-fraud provisions of the securities laws. Since the Commission failed to find that Steadman acted with the requisite intent, he would have us set aside its decision and order. There is some support for this position. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214, 96 S.Ct. 1375, 1391, 47 L.Ed.2d 668 (1976), the Supreme Court decided that scienter must be proved in a private damage action under rule 10b-5. Whether that holding should be extended to Commission enforcement actions under the statutes that Steadman was found to have violated is the question before us. We turn to an examination of each relevant section.

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[4] *McDonough v. Champburger Corp.*, 488 F.2d 948 (5th Cir. 1974), does not require a contrary result. We there decided that the omitted facts were not material because other disclosed facts adequately revealed the possible conflict of interest, if indeed there was one at all. *Id.* at 952. Steadman and SSC disclosed no facts concerning their borrowings from the banks.

1. Section 10(b) of the Exchange Act.

The Commission found that Steadman violated section 10(b) of the Exchange Act and rule 10b-5, section 17(a) of the Securities Act, and sections 206(1) and (2) of the IAA. In *SEC v. Blatt*, 583 F.2d 1325, 1333 (5th Cir. 1978), we held that the Commission must prove scienter in an injunctive action under section 10(b). Steadman contends that this holding compels the conclusion that scienter also is required in a disciplinary enforcement action such as this one.[5] Because the Commission failed to indicate whether it considered the other violations independent and sufficient bases for the sanctions imposed, the argument continues, we should reverse the decision.

We need not decide what state of mind must be shown in a disciplinary action for a violation of section 10(b), for the Commission has indicated to our satisfaction that the section 10(b) violation is mere surplusage in this case. In its opinion, in the context of distinguishing the *Hochfelder* case, the Commission stated:

> The instant case does not resemble *Hochfelder*. This is not a private action for money damages. It is a proceeding intiated by a public authority for the prophylactic purpose of preventing future harm to the public interest. Nor does this case rest solely on

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[5] The *Blatt* case was brought pursuant to section 21(d) of the Exchange Act, 15 U.S.C. § 78u(d) (1976), which authorizes the Commission to seek injunctive relief in district court for violations of that act. The case before us is an administrative proceeding under section 15(b) of the Exchange Act, 15 U.S.C. § 78*o*(b)(1976), section 9(b) of the of the ICA, 15 U.S.C. § 80a-9(b) (1976), and section 203(f) of the IAA, 15 U.S.C. § 80b-3(f) (1976).

> Rule 10b-5[30] *Indeed, it does not turn on 10b-5 at all.* The references to that rule in the order for proceedings and in this opinion are merely cumulative.
>
> [30] Section 17(a) of the Securities Act and the provisions of the Investment Company Act . . . are independent bases for liability.

____ S.E.C. at ____, [1977-1978 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 81,243, at 88,339-10 (three footnotes omitted) (emphasis added). The clear import of these words is that section 10(b) and rule 10b-5 are not essential to the opinion and order.

2. Section 17(a) of the Securities Act.

Section 17(a) of the Securities Act provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(1976). In *Hochfelder* the Court noted that the language of rule 10b-5 appears to have been derived in

significant part from this section.[6] *Hochfelder* held that scienter is required under rule 10b-5. Petitioner argues that this indicates strongly that scienter also is required under section 17(a).

Hochfelder exposes the sophistry in this argument. The Court imposed a scienter element on rule 10b-5 because the rule can be no broader than its parent statute, section 10(b) of the Exchange Act, whose language the Court interpreted to require an intent to defraud.[7] Section

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[6] Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1978).

[7] Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1976).

17(a) is, of course, a congressional enactment, not an administrative rule, and its language is quite different from that of section 10(b). Indeed, in a passage that cuts against Steadman's position, the Court stated:

> Viewed in isolation the language of subsection (b), and arguably that of subsection (c) [of rule 10b-5], could be read as proscribing, respectively, any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors, *whether the wrongdoing was intentional or not.*

425 U.S. at 212, 96 S.Ct. at 1390 (emphasis added). Subsections (b) and (c) of rule 10b-5 are nearly word-for-word identical with subsections (2) and (3) of section 17(a), respectively. We think that the Court would regard these subsections of section 17(a) as requiring no intent to defraud.

Steadman responds that the Securities Act and the Exchange Act have traditionally been construed in pari materia, and that to impose a scienter requirement under one but not the other would disrupt the "single comprehensive scheme of regulation" that these statutes form. *Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1286 (2d Cir. 1969), *cert. denied*, 397 U.S. 913, 90 S.Ct. 913, 25 L.Ed.2d 93 (1970). But *Hochfelder* observes that Congress fashioned standards of fault under these acts on a particularized basis. "Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section." 425 U.S. at 200, 96 S.Ct. at 1384. We turn then to an examination of the language of section 17(a).

We are not the first to travel this road. In *SEC v. Coven*, 581 F.2d 1020 (2d Cir. 1978), *cert. denied*, 440 U.S. 950, 99 S.Ct. 1432, 59 L.Ed.2d 640 (1979), the Second

Circuit, in a well-reasoned opinion that included a canvass of the legislative history, concluded that scienter is not required in an SEC injunctive action under subsection 17(a)(2). We adopt that conclusion for the reasons given in the *Coven* opinion. *Accord, SEC v. American Realty Trust*, 586 F.2d 1001, 1005-06 (4th Cir. 1978); *SEC v. Southwest Coal & Energy Co.*, 439 F.Supp. 820, 826 (W.D.La.1977), *appeal docketed*, No. 78-1130 (5th Cir. Jan. 17, 1978). Moreover, we adopt the further suggestion in *Coven* that "the clear import of the critical phrase in subsection (3), 'operates as a fraud,' is to focus attention on the *effect* of potentially misleading conduct on the public, not on the culpability of the person responsible." 581 F.2d at 1026 (emphasis in original) (footnote omitted). When construing identical language in section 206(2) of the IAA, see note 10 *infra*, language which was undoubtedly copied from subsection 17(a)(3), the Supreme Court said: "Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit' upon a client, did not intend to require proof of intent to injure . . . ." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195, 84 S.Ct. 275, 284, 11 L.Ed.2d 237 (1963).[8] Steadman objects that *Coven* is distinguishable as an *injunctive* action in which the Commission need only prove that the defendant is about to engage in unlawful conduct, *i.e.*, not every element of a section 17(a) violation need be proved. We think that *Coven's* analysis of the statutory language does not depend on the character of relief sought; the words used by Congress carry the same

[8] Read literally, subsection 17(a)(3) requires a finding that the course of business in which Steadman engaged operated as a fraud on the funds' shareholders. The Commission made no such finding in this case. A remand for rectification of this lapse would be a wasted gesture, however, because *Capital Gains* holds that nondisclosure of a material fact is conduct that "operates as a fraud or deceit" within the meaning of section 206(2) of the IAA. 375 U.S. at 198-99, 84 S.Ct. at 286. We think the same conclusion is inescapable under subsection 17(a)(3).

meaning regardless of whether the SEC seeks an injunction or a stronger sanction. As we shall discuss, the severity of the sanctions affects the factual showing necessary to support them, but it does not affect the basic elements of the offense. Accordingly, we hold that scienter need not be proved to establish violations of subsections 17(a)(2) and (3).[9]

We come now to subsection 17(a)(1). This clause contains the word "device" that the Supreme Court in *Hochfelder* found to be suggestive of intentional conduct when read together with "manipulative" and "deceptive." 425 U.S. at 197, 96 S.Ct. at 1383. The latter two words do not appear in subsection 17(a)(1), but the three words of that section—device, scheme, and artifice—must each be read in conjunction with the words "to defraud." The resulting phrases—device to defraud, scheme to defraud, artifice to defraud—carry strong implications of intentional conduct. We do not think Congress would have used such language if it meant to reach merely negligent actions. The use of the term "employ" further supports our reading of the section. *See Hochfelder*, 425 U.S. at 199 n.20, 96 S.Ct. at 1384.

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[9] Steadman argues that *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 794-96 (7th Cir. 1977), suggests a contrary result. On the assumption that a private right of action for damages exists under subsection 17(a)(2), a question it did not resolve, the Seventh Circuit there commented that scienter must be proved in such an action, for to interpret the subsection otherwise would nullify other sections of the Securities Act that specifically provide for private actions. We cannot agree with Steadman's contention that the logic in *Sanders* should control in the type of proceeding now before us. Even if scienter may be required to harmonize a hypothetical implied private cause of action with the rest of the act, there is no reason to hold scienter an element of the action specifically contemplated by the statute.

In adjudicating a violation of section 17(a), the Commission failed to find that Steadman acted with an intent to defraud, and thus an essential element of a subsection 17(a)(1) violation is missing. There is an indication in a footnote to the Commission's opinion that the section 17(a) infraction rests only on subsections (2) and (3). *See* ____ S.E.C. at ____ n.31, [1977-1978 Transfer Binder] Fed.Sec.L.Rep. ¶ 81,243, at 88,339-10. Perhaps this oblique footnote sufficiently conveys the SEC's intent to disclaim reliance upon subsection 17(a)(1). To the extent that the SEC relied upon subsections (2) and (3) of section 17(a), under which scienter is not a requirement, the violations are supported by substantial evidence and we would affirm; nevertheless, since we find other reasons to send this case back for reconsideration, the Commission on remand can clarify its opinion with regard to the subsections of section 17(a) that it considers were violated.

3. Sections 206(1) and (2) of the IAA.

What we have said in discussing section 17(a) of the Securities Act applies equally to the language of subsections (1) and (2) of section 206 of the IAA.[10] The wording of these provisions, which make it unlawful for an investment adviser "(1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or

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[10] Section 206 provides in part:

> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

15 U.S.C. § 80b-6(1), (2) (1976).

prospective client," is drawn from subsections 17(a)(1) and (3), respectively. As we already have noted, the Supreme Court has ruled that scienter is not required under section 206(2). *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. at 195, 84 S. Ct. at 284. The Court in that case said nothing about part (1) of section 206. We think that the language of this subsection must be construed to have the same meaning as subsection 17(a)(1), for to do otherwise would produce a serious anomaly; language copied directly from the Securities Act would have a different meaning under the IAA. We are aware that in *Capital Gains*, the Court emphasized that the intent of the IAA was to impose fiduciary standards on investment advisers. This general purpose for the statute argues in favor of liability for negligence alone, but "[a]scertainment of congressional intent with respect to the standard of liability created by a particular section . . . must . . . rest primarily on the language of that section." *Hochfelder*, 425 U.S. at 200, 96 S.Ct. at 1384. The language of section 206(1) clearly connotes intentional conduct and nothing in either the House or Senate Committee reports indicates that this phrase in the IAA is to be interpreted differently than the same phrase in the Securities Act. *See* H.R.Rep.No.2639, 76th Cong., 3d Sess. (1940); S.Rep.No.1775, 76th Cong., 3d Sess. (1940). Although the violation of section 206(2) can be supported without a showing of scienter, here the Commission found a violation of section 206(1) without finding the requisite scienter. Because the Commission's findings do not support some of the violations, we remand so that the Commission can reconsider whether it would impose the same sanctions under the violations we uphold.

II. Advisory Fees

SSC's management contract with at least two of the mutual funds limited SSC's annual advisory fee to one percent of each fund's average net assets. Apparently the

fee was paid in installments throughout the year based on estimates of the assets under management. At the end of the fiscal year,[11] because of a sharp decline in value of these funds' assets, it became clear that payments to SSC had exceeded the contractual maximum. Thus SSC owed the two funds a total of $260,000. SSC did not refund the money immediately. Instead, it suggested, and the funds' directors agreed, that the overrun would be repaid in installments at six percent interest.

On these facts the Commission found that SSC had received "compensation" within the meaning of subsection 15(a)(1) of the Investment Company Act of 1940(ICA), 15 U.S.C. § 80a—15(a)(1) (1976), because the obligation to refund the fees arose as soon as the fiscal-year-end computations were made, and SSC reaped an economic benefit by stretching out the repayments. Subsection 15(a)(1) prohibits an adviser from receiving "compensation" not "precisely" described in the advisory contract.[12] Because SSC's contracts did not provide for extended payment terms for fee overruns, the Commission held SSC in willful violation of the section and found that Steadman had aided and abetted the violations.

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[11] The relevant fiscal year ended on June 30, 1970, for one fund and on January 31, 1971, for the other.

[12] Section 15(a) provides in part:

> It shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, has been approved by the vote of a majority of the outstanding voting securities of such registered company, and—
>
> (1) precisely describes all compensation to be paid thereunder;

15 U.S.C. § 80a-15(a)(1)(1976).

Steadman attacks these conclusions on several bases. He first argues that the arrangements made between SSC and the funds for repayment of the advisory fee overruns cannot reasonably be considered compensation to SSC. He cites as authority *In re Imperial Financial Service, Inc.*, 42 S.E.C. 717, [1964—1966 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 77,287 (1965), in which the SEC refused to hold that a loan, repaid at seven percent interest, constituted compensation to an affiliated borrower. The Commission responds that it explicitly noted in *Imperial* that in a given case an interest-bearing loan could be treated as compensation under the ICA, but because seven percent was a very generous rate at the time, the Commission did not decide whether that loan was compensation. Here, it points out, six percent was a very low rate for the time, and even if the interest were at market rate,[13] the funds' forbearance to demand immediate payment of the amount due was a substantial economic benefit to SSC.

We think the Commission has the better argument. In *Imperial*, it did not foreclose itself from treating as compensation the type of repayment schedule involved here. The question presented is a rather technical one, and substantial deference is due the construction of a statute made by those charged with its execution. *E. I. du Pont de Nemours & Co. v. Collins*, 432 U.S. 46, 54, 97 S.Ct.

[13] Steadman and the Commission are unable to agree what the prime rate for commercial loans was at the time. The SEC says eight percent, Steadman says six to six-and-one-half percent. Even taking Steadman's best figure—six percent—it is clear that he was getting a good deal, because the best rate he was able to negotiate with a commercial bank on the loans discussed in Part I was one-half percent over prime. Moreover, the portfolio manager for one of the funds testified that in November 1970, the same time frame when these over-runs were due, the funds could get eight-and-one-half to nine percent by investing in short term commercial paper. Joint App. at 94.

2229, 2234, 53 L.Ed.2d 100 (1977). The Commission's construction is not unreasonable, and we uphold it.

Steadman fares no better with his other contentions. That the arrangement was approved by the funds' directors and on the advice of counsel does not render the violation any less willful, for "willful" in this context simply means that the act constituting the violation was done intentionally; "[t]here is no requirement that the actor also be aware that he is violating one of the Rules or Acts." *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 (2d Cir. 1976) (footnote omitted) (quoting *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965)), *cert. denied*, 434 U.S. 1009, 98 S.Ct. 719, 54 L.Ed.2d 752 (1978). As to the finding that Steadman aided and abetted the violation, his control of SSC is a substantial ground for the inference that he was involved in every important activity of that company, and there is independent evidence in the record to support this inference.

Finally, Steadman points out that in finding that the failure to disclose the installment repayment arrangement was a violation of the antifraud provisions, see footnote 1, paragraph 3, *supra*, the Commission failed to find that the omitted facts were material. It is true that the Commission did not explicitly state in its opinion that these facts were material, but it adopted the Administrative Law Judge's findings that the antifraud statutes had been violated, and we think it sufficiently clear that the SEC also adopted the finding that these facts were material.

III. Tender Solicitation Fees

In 1969, tender offers were made for securities held by three of the Steadman funds. In accordance with the custom in the industry, the offerors paid tender solicitation fees to brokers who successfully solicited their

clients to tender their shares. The funds' shares were tendered through Republic Securities Corporation (RSC), a wholly owned broker-dealer subsidiary of SSC. RSC collected tender solicitation fees equal to two percent of the value of the securities tendered—about $32,000. RSC kept half of this amount and paid the other half to the tendering funds.

Subsection 17(e)(1) of the ICA, 15 U.S.C. § 80a-17(e)(1) (1976), prohibits an affiliated person of an investment company from receiving compensation for the sale of the company's property except in the course of his business as a broker.[14] The Commission found that RSC

[14] The full text of section 17(e) provides:

> It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person—
>
> (1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker; or
>
> (2) acting as broker, in connection with the sale of securities to or by such registered company or any controlled company thereof, to receive from any source a commission, fee, or other remuneration for effecting such transaction which exceeds (A) the usual and customary broker's commission if the sale is effected on a securities exchange, or (B) 2 per centum of the sales price if the sale is effected in connection with a secondary distribution of such securities, or (C) 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected unless the Commission shall, by rules and regulations or order in the public interest and consistent with the protection of investors, permit a larger commission.

RSC thought it was complying with the one percent limitation of subsection (2)(C) when it remitted half the fee to the funds.

was not acting as a broker in this transaction and therefore should have paid all of the fees it received to the tendering funds:

> Where no brokerage is needed, no fee may be collected. These fees paid were to "soliciting brokers." Republic did no soliciting. It merely transmitted the tendered securities. No broker was needed for that.
>
> The decision to tender had already been made by the investment adviser. For making such decisions it received an advisory fee. It could not pocket a second fee for the very same service by donning its broker-dealer hat.

____ S.E.C. at ____, [1977-1978 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 81,243, at 88,339-15 (footnotes omitted). In support, the SEC cites its decision in *In re Provident Management Corp*, 44 S.E.C 442, [1970-1971 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 77,937 (1970),[15] where it found improper the retention of tender solicitation fees by an affiliated broker who performed no "compensable services."

There is no dispute that RSC is an affiliated person of the tendering funds. Steadman contends, however, that RSC performed substantial services for the funds in gathering the shares and effecting the transfers and that these were brokerage services for which it could collect a fee. Steadman attacks the conclusion that "where no brokerage is needed, no fee may be collected" as novel and

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[15] Steadman's attack on the precedential value of *Provident* is without merit. Although that opinion was issued in connection with an offer of settlement, the Commission's construction of the securities laws in settled cases as well as litigated ones is entitled to great weight. *E. I. duPont de Nemours & Co. v. Collins*, 432 U.S. 46, 54, 97 S.Ct. 2229, 2234, 53 L.Ed.2d 100 (1977).

unsupported. He also argues that the funds accrued a net benefit on the transaction since the whole two percent fee would have been lost to them if they had used an unaffiliated broker, whereas by using RSC they collected half the fee.

We think that we must defer to the Commission's expertise on this issue also. Its argument that the services performed by RSC were part of what the funds were paying their manager, SSC, to do is not unreasonable. Section 17(e) was intended to prohibit conflicts of interest between a fund and affiliated persons advising it on portfolio transactions. *United States v. Deutsch*, 451 F.2d 98, 109 (2d Cir. 1971), *cert. denied*, 404 U.S. 1019, 92 S.Ct. 682, 30 L.Ed.2d 667 (1972). SSC faced such a conflict in advising the funds whether to tender, knowing that its subsidiary would pocket a fee if they did. That the funds might also gain is no answer. Accordingly, the Commission's finding of section 17(e) violations by RSC is affirmed. There is substantial evidence to support the conclusion that Steadman aided and abetted the violations. He personally reviewed the accounting treatment given the transaction and ordered the splitting of the fees between RSC and the funds. Hence, we also affirm the Commission's finding that Steadman violated section 17(e).

IV. Reporting Violations

By the terms of its management contracts with the funds, SSC undertook to see that the funds filed with the SEC reports required by law. The annual reports for at least three funds were filed late for three consecutive years, 1970 to 1972, and the annual reports for Steadman's four broker-dealer companies were late in both 1971 and 1972. In the Commission's view, the principal problem involved the 1971 reports. These were filed more than a

year late, " 'so late as to be of minimal value in serving the purposes intended by the requirements for filing the reports.' " ____ S.E.C. at ____, [1977-1978 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 81,243, at 88,339-16 (quoting from Administrative Law Judge's Initial Decision).

Steadman does not deny that the reports were late. He does not dispute that the applicable statutes were thus violated, see note 1, paragraph 5, *supra*; he simply contends that there is no evidence that the violations were willful. He points out that it is uncontested that it took seven months to replace SSC's controller after he resigned in 1971, that SSC's independent auditor was changed in the same year, and that SSC sought but was denied extensions for at least some of the reports.

The Commission responds that these facts in mitigation do not excuse the violations or render them less willful. We agree. The record discloses that as early as 1969, SSC's auditors were advising Steadman of serious deficiencies in the accounting procedures and internal organization, including the lack of sufficient personnel, of SSC and its subsidiaries. They warned that the growth in assets under management had not been matched by changes necessary to handle the increased workload. In 1970, under pressure from the banks to meet his loan payments, Steadman implemented a stringent cost-cutting drive that included a significant reduction in personnel. His problems were thus of his own making. On these facts, the Commission was justified in concluding that Steadman was more interested in economizing than in maintaining the organization necessary to manage the funds properly.

V. Sanctions and Burden of Proof

Steadman's principal argument for reversal of the Commission's order is that the wrong burden of proof was used in the administrative proceedings. We have reserved

treatment of this issue for discussion in conjunction with his attack on the severity of the sanctions imposed upon him because, in our view, the two are closely related. We conclude that when the Commission chooses to order the most drastic remedies at its disposal, it has a greater burden to show with particularity the facts and policies that support those sanctions and why less severe action would not serve to protect investors.

A. *Burden of Proof*

The Commission applied a "preponderance of the evidence" standard in this case. Steadman cites *Collins Securities Corp. v. SEC*, 183 U.S.App.D.C. 301, 562 F.2d 820 (D.C.Cir. 1977), for the proposition that a "clear and convincing evidence" standard is required. In *Collins*, the defendant was charged with manipulating the market for the shares of a particular company in violation of various antifraud provisions of the securities laws. The court acknowledged that the traditional standard of proof in administrative proceedings is the preponderance of the evidence. It expressed concern, however, that in a securities case involving allegations of fraud the evidence is often circumstantial in nature and requires to a significant degree the drawing of inferences to establish the violation. In addition, on the basis of this inferential proof the administrative agency may impose sanctions amounting in effect to a deprivation of livelihood. Thus the court discerned "a need to subject such evidence to a standard which will ensure that any remedial sanctions are imposed only in those circumstances where the evidence is of such a quality as to make the sanctions appear just and reasonable." *Id.* at 304, 562 F.2d at 823. After noting that the clear and convincing evidence standard has been imposed in certain other types of cases, most notably those involving civil fraud, the court concluded that, for SEC disciplinary proceedings in fraud cases, this

standard drew the necessary "realistic correlation between the burden of persuasion and the available remedies." *Id.* at 307, 562 F.2d at 826.

Other cases cited by petitioner are relevant but not directly on point. In *Addington v. Texas*, ____ U.S. ____, 99 S.Ct. 1804, 60 L.Ed.2d 323 (1979), the Supreme Court decided that the fourteenth amendment requires at least the clear and convincing evidence standard in civil involuntary commitment proceedings. In a general discussion of the function of a standard of proof, the Court noted:

> One typical use of the [clear and convincing] standard is in civil cases involving allegations of fraud or some other quasicriminal wrongdoing by the defendant. The interests at stake in those cases are deemed to be more substantial than mere loss of money and some jurisdictions accordingly reduce the risk to the defendant of having his reputation tarnished erroneously by increasing the plaintiff's burden of proof.

Id. at ____, 99 S.Ct. at 1808. The case before the Court did not, of course, involve allegations of fraud, and no holding was made respecting such cases. In requiring more than a mere preponderance of evidence for civil commitment, the Court focused primarily on the deprivation of liberty entailed in confinement; it also noted that "adverse social consequences" can result from involuntary commitment to a mental hospital. *Id.* at ____, 99 S.Ct. at 1809.

Spevack v. Klein, 385 U.S. 511, 87 S.Ct. 625, 17 L.Ed.2d 574 (1967), and *In re Ruffalo*, 390 U.S. 544, 88 S.Ct. 1222, 20 L.Ed.2d 117 (1968), also cited by Steadman, both hold that disbarment from the practice of law is a penalty that triggers the minimum protections of due process—notice, a hearing, and the right not to testify against oneself.

Steadman does not suggest that he was denied these protections in this case; rather, he argues that due process also requires a heightened standard of proof before he may be barred permanently from his profession.

To the extent that *Collins* rests on a concern that there are particular risks for a respondent in a fraud proceeding because the proof is necessarily circumstantial and inferential, we are not persuaded. In his proceeding, the only fact to which Steadman points as being based on disputed inferences is his state of mind—whether he acted with an intent to defraud. But we have held that scienter is not an element of a violation of subsections (2) and (3) of section 17(a) of the Securities Act or of section 206(2) of the IAA, statutes on which the Commission relies to a significant degree in this case. These are commonly called "antifraud" provisions, but the offenses they define are fraud in the broadest "remedial" sense of that term and require no showing of intent to injure or injury. *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195, 84 S.Ct. 275, 284, 11 L.Ed.2d 237 (1963). The facts necessary to establish a violation of these sections—nondisclosure of a material fact—are capable of proof by ordinary direct or circumstantial evidence as in any other administrative proceeding.

We are more impressed by Steadman's argument that the potential for severe sanctions that results from violation of these sections demands a higher burden of proof. Before the Commission, Steadman faced indefinite exclusion from the investment advisory business and the forced sale of all his interest in SSC. The order the Commission rendered is indistinguishable in its effect on the respondent from disbarment from the practice of law. While many jurisdictions use a preponderance standard in disbarment proceedings, many others apply a higher standard. *See* 7 C.J.S. *Attorney & Client* § 33a(3) (1937 & Supp.1979); 7 Am.Jur.2d *Attorneys at Law* § 67 (1963 &

Supp.1979) (collecting cases). The higher standard rests in large part on the concern that disbarment means deprivation of livelihood. *See, e. g., In re Fisher*, 179 F.2d 361, 369-70 (7th Cir.), *cert. denied*, 340 U.S. 825, 71 S.Ct. 59, 95 L.Ed. 606 (1950).

We are reluctant to say, however, that in all disciplinary proceedings under the securities antifraud provisions the Commission must prove its case by clear and convincing evidence. Debarment from the industry is not the only sanction the SEC can impose. The available remedies also include mere censure, limitation of the respondent's activities, or suspension for up to twelve months. 15 U.S.C. § 80b-3(f) (1976).[16] Thus, the stakes are not as high for every respondent in a Commission proceeding as they came to be for Steadman.

The burden of proof serves to allocate between the litigants the risk of erroneous decision in a proceeding. *Addington v. Texas*, ____ U.S. at ____, 99 S.Ct. at 1808. Balanced against the risk to Steadman is the risk that the investing public will be inadequately protected. The public interest in high standards of conduct in the securities business is a great one. If the burden of proof imposed on the Commission is too high, its ability to police the industry is impaired. We cannot say here, as the Court could in *Addington v. Texas*, *id.* at ____, 99 S.Ct. at 1810, that "the possible injury to the individual is significantly greater than any possible harm to the state." Accordingly, we do not see why they should not bear the risk of error equally.

We do not wish to minimize the seriousness of the sanctions laid upon Steadman. From his perspective,

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[16] In addition, 15 U.S.C. § 80a-9(b) (1976) permits the permanent or temporary, conditional or unconditional, prohibition of service of an officer, employee, or director of a registered investment adviser.

exclusion from the industry is clearly a penalty. *See Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 n.6 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009, 98 S.Ct. 719, 54 L.Ed.2d 752 (1978); *cf. In re Ruffalo*, 390 U.S. at 550, 88 S.Ct. at 1226 (disbarment is a penalty). *But see Blaise D'Antoni & Associates v. SEC*, 289 F.2d 276, 277(5th Cir.) (revocation of broker registration not a penalty), *cert. denied*, 368 U.S. 899, 82 S.Ct. 178, 7 L.Ed.2d 95 (1961). But imposing a high burden of proof to establish the facts of a securities-laws violation is not the only means to protect a respondent. We are empowered to set aside Commission orders that are arbitrary and capricious. 5 U.S.C. §§ 551, 702, 706, (1976). We subscribe to the common-sense notion that the greater the sanction the Commission decides to impose, the greater is its burden of justification. Where, as here, the most potent weapon in the Commission's "arsenal of flexible enforcement powers," *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195, 96 S.Ct. 1375, 1382, 47 L.Ed.2d 668 (1976), is used, the Commission has an obligation to explain why a less drastic remedy would not suffice.

We have not lost sight of the limitations on our power to review administrative sanctions. Our role is to decide only whether, under the applicable statute and the facts as found, the agency has made "an allowable judgment in its choice of the remedy." *Jacob Siegel Co. v. FTC*, 327 U.S. 608, 612, 66 S.Ct. 758, 760, 90 L.Ed. 888 (1946), *quoted in Butz v. Glover Livestock Commission Co.*, 411 U.S. 182, 189, 93 S.Ct. 1455, 1459, 36 L.Ed.2d 142 (1973). The fashioning of an appropriate and reasonable remedy is for the Commission, not this court, and the Commission's choice of sanction may be overturned only if it is found "unwarranted in law or . . . without justification in fact." *American Power & Light Co. v. SEC*, 329 U.S. 90, 112-13, 67 S.Ct. 133, 146, 91 L.Ed. 103 (1946), *quoted in Butz v. Glover Livestock Commission Co.*, 411 U.S. at 185-86, 93 S.Ct. at 1458. In our

view, however, permanent[17] exclusion from the industry is "without justification in fact" unless the Commission specifically articulates compelling reasons for such a sanction. For example, the facts of a case might indicate a reasonable likelihood that a particular violator cannot ever operate in compliance with the law, *see SEC v. Blatt*, 583 F.2d 1325, 1334 (5th Cir. 1978), or might be so egregious that even if further violations of the law are unlikely, the nature of the conduct mandates permanent debarment as a deterrent to others in the industry, see p. 1142 *infra*. We do not intend to limit the Commission by indicating these possible grounds for debarment, but rather give them as examples of the type of situation that would seem to justify that penalty.[18] With this in mind, we proceed to examine the sanctions imposed upon Steadman.

B. *The Sanctions*

In its brief, the Commission has candidly conceded that Steadman's status as a fiduciary to the funds was "vitally significant" in assessing the seriousness of his conduct. Respondent's Brief at 67. The opinion under review concludes that Steadman was "egregiously faithless" in that role because of (1) his intentional and protracted concealment of his banking relationships and (2) his causing flagrant and intentional breaches of his companies' contractual and fiduciary duties to see that the funds fulfilled their reporting obligations. ____ S.E.C. at ____ & n.90, [1977-1978 Transfer Binder] Fed.Sec.L.Rep.

[17] "Permanent" in this context really means "indefinite" since the Commission retains the power to modify its orders. *See In re Steadman Securities Corp.*, ____ S.E.C. at ____ n.100, [1977-1978 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 81,243, at 88,339-23. This does not make the sanction less severe, however.

[18] The Commission might consider modelling its use of, and explanation for, debarment after the way in which disbarment has been enforced against certain members of the legal profession.

(CCH) ¶ 81,243, at 88,339-20. Harsh sanctions were imposed because the misconduct in this case was particularly serious, and past misconduct gives rise to an inference of probable future misconduct. Leniency in this case, it was felt, would pollute the ethical climate in the industry and encourage others to act irresponsibly.

We do not agree with Steadman that the Commission has unconstitutionally made a conclusive presumption of future wrongdoing on the basis of past misconduct, but we do agree that a fuller explanation of the need for these sanctions is required. At least the Commission specifically ought to consider and discuss with respect to Steadman the factors that have been deemed relevant to the issuance of an injunction:

> the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

SEC v. Blatt, 583 F.2d at 1334 n.29. To say that past misconduct gives rise to an inference of future misconduct is not enough. What is required is a specific enumeration of the factors in Steadman's case that merit permanent exclusion.

We heartily endorse the Commission's view that while scienter is not required to make out violations of several of the statutory sections involved here, the respondent's state of mind is highly relevant in determining the remedy to impose. It would be a gross abuse of discretion to bar an investment adviser from the industry on the basis of isolated negligent violations. More than that was shown here, however. The Commission found that the

concealment of Steadman's collateral banking relations was "systematic, calculated and protracted," ____ S.E.C. at ____, [1977-1978 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 81,243, at 88,339-11; accordingly, it found that he and his corporate instrumentalities intended to deceive. This conclusion is markedly undercut, though, by the Commission's refusal to adopt the Administrative Law Judge's finding that the funds' custodial accounts were intentionally offered to the banks as an inducement to make the loans.[19] Such a finding by the Commission would have significantly strengthened its conclusion that the failure to disclose the loans was intended to deceive. Use of the funds' custodial accounts as leverage to obtain loans for the adviser and its president would be an obvious and serious breach of fiduciary duty, the concealment of which clearly would have been fraudulent. In the absence of such a finding, we have only the coincidence that Steadman and SSC borrowed from the funds' custodians. We do not retreat from our affirmation that these facts were material, but they are less supportive of an intent to deceive than other conclusions the record arguably permits. We do not say there is a lack of substantial evidence to support the finding of scienter—there is such support—but in considering what sanctions the Commission's opinion will justify, we think the Commission has not articulated a sufficient justification for expulsion from the industry.

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[19] There is no satisfactory explanation for the Commission's failure to make this finding except that it was considered unnecessary. The opinion notes that the live testimony at the hearing was against a causal link, and the documentary evidence supporting such a link was received by the Administrative Law Judge over Steadman's objections to its admissibility and probative weight. Therefore, the Commission concluded, "questions of fact are raised. We do not reach them." ____ S.E.C. at ____, [1977-1978 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶81,243, at 88,339-13 (footnote omitted).

We also are troubled by the Commission's position that it may consider violations of section 36(a) of the ICA, 15 U.S.C. § 80a-35(a) (1976),[20] in assessing sanctions for violations of other sections of the securities laws.[21] Section 36(a) permits the Commission to apply to a federal district court for an injunction against an officer of an investment adviser who has engaged or is about to engage in acts constituting "a breach of fiduciary duty involving personal misconduct." It gives no power to the Commission, an administrative agency, to adjudicate such breaches, and the Commission has held that it cannot do so. *In re Carl L. Shipley*, ____ S.E.C. ____, [1973-1974 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 79,833 (1974). Here, the Commission reaffirms a position it took in dicta in *Shipley*: in a proceeding where it finds willful violations

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[20] 15 U.S.C. § 80a-35(a) provides:

> The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

[21] The statutes commonly referred to as the ICA and the IAA were enacted as titles I and II respectively of the Act of August 22, 1940, ch. 686, 54 Stat. 789 (codified at 15 U.S.C. §§ 80a-1 to 80a-52, 80b-1 to 80b-21 (1976)). Section 9(b) of title I, 15 U.S.C. § 80a-9(b) (1976), and section 203(f) of title II, *id.* § 80b-3(f), both authorize the Commission to bar persons from the investment adviser and investment company business for willful violations of any provision of title I or title II, the Securities Act, or the Exchange Act. The ICA and the IAA therefore overlap, and, as a general matter, it is not improper to refer to violations of one in assessing sanctions under the other. However, as we explain, this does not mean the Commission may poach on the jurisdiction entrusted solely to a federal district court.

of other provisions of the securities laws, on the issue of sanctions it may consider whether the respondent has also violated section 36(a). We agree that section 36(a) is a "reservoir of fiduciary obligations imposed upon affiliated persons to prevent gross misconduct or gross abuse of trust not otherwise specifically dealt with in the Act." *Brown v. Bullock*, 194 F.Supp. 207, 238-39 n.1 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961). But responsibility for its enforcement is vested in the courts, not the Commission. The statutory distinction between the functions of the agency and the courts would be effectively read out of the law if the Commission could bring section 36(a) into its own enforcement proceedings through the back door by professing reliance upon it only at the stage of assessing sanctions. We are aware that *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. at 191-92, 84 S.Ct. at 282-83, emphasizes that the purpose of the IAA (and, by implication, the ICA, see note 21 *supra*) was to regulate the "delicate fiduciary nature of an investment advisory relationship." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. at 191, 84 S.Ct. at 283 (quoting 2 L. Loss, Securities Regulation 1412 (2d ed. 1961)). We do not think this overall purpose is a warrant to read sections 206(1) and (2) of the IAA, the sections found to have been violated here, as the vehicle to reach all breaches of fiduciary trust. The Court in *Capital Gains* relied on the broad purpose of the statute to hold that section 206(2) does not require a showing of scienter, but that is far from adopting the position the Commission takes here. The Commission may impose sanctions only for violations of the statutes assigned to its jurisdiction, and that does not include section 36(a). This is not to say that in imposing sanctions, the Commission may not consider violations occurring in the context of a fiduciary relationship to be more serious than they otherwise might be. This is not due to any contribution from section 36(a), however, but because the "public interest" the Commission is required

to consider in fashioning its orders must be construed liberally to effectuate the prophylactic purpose of the securities laws. *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. at 195, 84 S.Ct. at 284-85.

As we have indicated, see p. 1139 *supra*, the Commission also may consider the likely deterrent effect its sanctions will have on others in the industry.[22] Permanent debarment, however, is not the only remedy at the Commission's disposal that acts as a deterrent; each of the remedies has that capacity to varying degrees. The Commission should articulate why a lesser sanction would not sufficiently discourage others from engaging in the unlawful conduct it seeks to avoid.

We remand this case to the Commission for reconsideration of its order in light of our holdings. We do not hold that the Commission abused its discretion here; we simply say that it impermissibly considered section 36(a) relevant to the issue of sanctions and failed to explain its reasoning in sufficient detail for us to assess the reasonableness of the remedies it ordered.[23]

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[22] *Arthur Lipper Corp. v. SEC*, 547 F.2d 171 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009, 98 S.Ct. 719, 54 L.Ed.2d 752 (1978), is not to the contrary. The court there said, "[t]he purpose of such severe sanctions [as revocation of registration and debarment from the industry] must be to demonstrate not only to petitioners but to others that the Commission will deal harshly with egregious cases." *Id.* at 184. The court rejected the sanctions because it found that under the circumstances of that case, the violations were not egregious. It did not reject the notion of deterrence as a proper factor for consideration.

[23] Steadman's argument that the Commission's order violates the ex post facto clause of the Constitution, U.S. Const. art. 1, § 9, cl. 3, is without merit. He correctly notes that prior to 1970, the Commission was without power to sanction persons, as opposed to companies, for violations of the IAA and ICA. These powers were added by the Investment Company Amendments Act of 1970, Pub.L.No.91-547, 84 Stat. 1413 (codified in scattered

(footnote continued)

V. CONCLUSION

We summarize here our holdings adverse to the Commission, which will affect the proceedings on remand:

1. Scienter is an element of a violation of subsection 17(a)(1) of the Securities Act, and section 206(1) of the IAA.

2. When the Commission imposes the most drastic sanctions at its disposal, it has a duty to articulate carefully the grounds for its decision, including an explanation of why lesser sanctions will not suffice.

3. Section 36(a) of the ICA may not be considered by the Commission in imposing sanctions for violations of other securities laws.

The petition for review is therefore granted in part and denied in part; the order is set aside and the cause is remanded for reconsideration consistent with this opinion.

REMANDED.

(footnote continued)

sections of 15 U.S.C.). Hence, he contends, to the extent the order is based on pre-1970 conduct it is invalid. The Commission provides two answers, either of which is sufficient. First, the violations continued well after 1970 and the same order would have issued if only post-1970 conduct were considered. ____ S.E.C. at ____ n.93, [1977-1978 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶81,243, at 88,339-21. Second, the amendments went only to remedy; they effected no substantive change in the law. Steadman's conduct was violative of the statute before and after 1970. Since it does not penalize an act innocent when done, the order is not ex post facto. *Calder v. Bull*, 3 U.S. (3 Dall.) 386, 390, 1 L.Ed. 648 (1798).

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

[CAPTION OMITTED IN PRINTING]

Before WISDOM, GODBOLD and TJOFLAT, Circuit Judges.

JUDGMENT

This cause came on to be heard on the petition of Charles W. Steadman, for review of an order of the Securities and Exchange Commission, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the order of the Securities and Exchange Commission in this cause be, and the same is hereby remanded to Securities and Exchange Commission in accordance with the opinion of this Court.

October 4, 1979

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

[CAPTION OMITTED IN PRINTING]

On Petition For Rehearing
(November 27, 1979)

Before WISDOM, GODBOLD and TJOFLAT, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby DENIED.

ENTERED FOR THE COURT:

/s/ [Illegible]
United States Circuit Judge

No. 79-1266

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1979

CHARLES W. STEADMAN,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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PETITIONER'S SUPPLEMENTAL APPENDIX

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March 1980

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 13695 / June 29, 1977

INVESTMENT COMPANY ACT OF 1940
Rel. No. 9830 / June 29, 1977

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 593 / June 29, 1977

Admin. Proc. File No. 3-3101

In the Matter of

STEADMAN SECURITY CORPORATION
1730 K Street, N.W.
Washington, D.C.
(801-8141)

CHARLES W. STEADMAN

REPUBLIC SECURITIES CORPORATION
(8-13223)

STEADMAN INVESTMENT SERVICES CORPORATION
(8-14704 and 801-5679)

THE STEADMAN CORPORATION OF AMERICA
(8-13995)

ABERDEEN MANAGEMENT CORPORATION
(8-1867)

OPINION OF THE COMMISSION

BROKER-DEALER AND INVESTMENT ADVISER PROCEEDINGS

Grounds for Remedial Action

Fraud

Late Filings

Receipt of Illicit Compensation from Registered Investment Companies by their Investment Adviser

Where an investment company complex's controlling person concealed material facts from investors, caused the entities that he controlled to breach their reporting obligations to the Commission, and also caused a registered investment adviser, all of whose voting stock he owned, to accept compensation from two of its advisee-investment companies that was not described in the advisory contracts, held, in public interest to bar that person from association with any investment adviser, to prohibit him permanently from serving or acting in any of the capacities enumerated in Section 9(b) of the Investment Company Act, and to suspend

him from association with any broker or dealer for 12 months. But order's effective date stayed for 90 days to facilitate an orderly transition in the management of the affected investment companies and to give the barred individual an opportunity to dispose of his controlling interest in the advisory organization.

Fraudulent Omissions to Disclose Material Facts

Bank Loans

Bank Deposits

Checking Accounts

Certificates of Deposit

Causal Relationships -- Significance of

Management -- Character of

Materiality

Willfulness

State of Mind

Intent to Defraud

Scienter

Applicability of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), to Administrative Proceedings

Applicability of Ernst & Ernst v. Hochfelder, supra, to cases arising under the Investment Company and Investment Advisers Acts

Investment company manager's concealment of his heavy borrowings from the very same banks in which he caused the investment companies to deposit large sums in non-interest bearing accounts, held, fraudulent and hence in willful violation of Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act, Rule 10b-5 under the latter section, Sections 206(1) and 206(2) of the Investment Advisers Act, Section 20(a) of the Investment Company Act and the Commission's rules thereunder, and also Sections 30 and 34(b) of the Investment

Company Act as well as the Commission's rules under the last two sections.

Investment company manager's heavy borrowings from the banks in which he caused his investment company clients to keep their cash, held, material to investors even in the absence of a causal link between the loans to the manager and the investment companies' deposits because "reasonable investors could reasonably have deemed the relationships corrupting."

A failure to disclose material facts by one charged with the duty to do so is willful even in the absence of intent to defraud.

Proof of intent to defraud, held, unnecessary in administrative proceedings under the Securities Exchange, Investment Company, and Investment Advisers Act. Scienter requirements of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), held, inapplicable to administrative proceedings initiated by the Commission.

Though relevant to administrative proceedings initiated by the Commission, scienter has no bearing on the willful violation issues in them. It goes only to the sanction question.

Advisory Contracts -- Advisory Compensation

Investment Company Managers -- Compensation

Interest-Bearing Loans and Extensions of Credit

Advisory Fees -- Overpayments of

Refunds -- Failure to Make when Due

Money -- Use of as Compensation

Brokerage -- As Compensation

Sections 15(a)(1) and 17(e)(1) of the Investment Company Act Construed

Advisory Contracts -- Requirements that all Compensation to be Paid Thereunder be Described

Where an investment company manager borrowed substantial sums, on which he paid interest, from the banks in which the investment companies kept their cash, held, such loans

were "compensation" to the manager. But they were not "compensation" for purposes of Section 15(a)(1) of the Investment Company Act. The only compensation that counts for purposes of Section 15(a)(1) is compensation paid by the investment company itself. On the other hand, such compensation does fall within the prohibitions of Section 17(e)(1) because that section reaches any compensation from any source.

Portfolio brokerage business at customary rates of commission obtained by investment adviser from the commercial banks in which his investment companies kept substantial sums on deposit, held, compensation to the adviser.

Loans and portfolio brokerage business obtained by an investment adviser to investment companies from the banks in which those companies kept substantial deposits, held, compensation to the adviser -- but not prohibited by Section 17(e)(1) of the Investment Company Act because neither purchases nor sales of the investment companies' property were involved. Checking accounts involve the rendition of services by the bank. No "property" interests are bought or sold.

A certificate of deposit issued by a commercial bank is "property" for purposes of Section 17(e)(1) of the Investment Company Act. But adverse findings, based on the purchase of such a certificate by a registered investment company whose investment adviser borrowed from the issuing bank, withheld, where causal connection between the investment company's purchase of the certificate and the issuing bank's loan to the investment adviser unclear.

Where registered investment companies overpaid their advisory fees, where the adviser did not refund such excess in toto as soon as the requisite computations were made but did so in monthly installments with interest at a rate appreciably below the then prevailing prime rate, and where such arrangements were not described in the advisory contracts, held, arrangements were in willful violation of Section 15(a)(1) of the Investment Company Act.

An investment adviser who uses money that belongs to his investment company client receives "compensation" from that client.

A bargain rate of interest is "compensation" moving from the recipient of such interest to the party paying it.

Joint or Joint and Several Participants

Combinations

Section 17(d) of the Investment Company Act Construed

Absent a finding of a causal nexus between the loans to the adviser and the deposits by the investment companies, a showing that an investment adviser borrowed money from the banks in which his investment company clients kept large sums on deposit, held, insufficient to establish a joint participation between the adviser, on the one hand, and the investment companies, on the other, for purposes of Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder.

Section 17(d) of the Investment Company Act does not reach every economic relationship in which a registered investment company is on one side and one of its affiliates on the other.

Some element of combination must be shown in order to bring Section 17(d) of the Investment Company Act to bear on a particular situation. If there is such a combination, the section applies even though the investment company is not a conscious participant.

Tender Solicitation Fees

Section 17(e)(1) of the Investment Company Act Construed

First Multifund of America, Inc., 44 S.E.C. 680 (1971), Distinguished

Where investment adviser to registered investment companies retained tender solicitation fees received from tender offerors who wanted to purchase and did purchase securities owned by the investment companies and did so without performing any necessary brokerage services, held, willful violation of Section 17(e)(1) of the Investment Company Act, which prohibits persons affiliated with registered investment companies from accepting any compensation (other than a regular salary or wages from the company) for the purchase or sale of any property to or for the company, except in the course of such person's business as an underwriter or broker.

Where an investment company needs no brokerage service, its affiliated person is precluded from collecting any brokerage fee.

One who receives an advisory fee from an investment company in return for his services

in formulating the company's investment decisions cannot pocket a second fee for the very same service by posing as a broker. In First Multifund of America, Inc., 44 S.E.C. 680 (1971), the investment company needed brokerage services in order to achieve its objective. Hence the affiliated broker was held entitled to compensation. In the tender offer situation on the other hand, the investment company needs no broker.

Late Filings

Public Interest Implications

Egregiously late filings of an investment company complex's required reports have grave public interest implications.

Investment Company Complexes -- Intercompany Transactions

Foreign Unregistered Investment Companies-Transactions with Affiliated Domestic Registered Investment Companies

Section 17(a) of the Investment Company Act Construed

Where a foreign unregistered investment company bought securities from and sold them to domestic registered companies that were under common control with it, held, transactions were in willful violation of Section 17(a) of the Investment Company Act.

Section 17(a) of the Investment Company Act prohibits members of an investment company complex from swapping securities with each other.

Where transactions in securities among members of an investment company complex were in willful violation of Section 17(a) of the Investment Company Act and where no exemption was available under the Commission's Rule 17a-7, because one of the companies involved was not registered under the Act, held, exemptive order should have been applied for and failure to seek it cannot be condoned. Nevertheless, such violations are of little weight in assessing sanctions because of their somewhat technical character, because there was no showing that violative conduct inflicted any harm and because they saved investors substantial brokerage commissions.

Control

Investment Companies -- Sole Investment Discretion

Investment Advisers to Investment Companies -- Nature of the Relationship

Independent Contractors

Stock Ownership

Section 2(a)(9) of the Investment Company Act Construed

Where an investment adviser to an unregistered foreign investment company had sole investment discretion with respect to its portfolio, held, the adviser controlled the company for purposes of Section 2(a)(9) of the Investment Company Act.

Control of an investment company's portfolio is control of the company itself.

An investment company's investment adviser is almost always in control of his investment company client. That is so even where he owns none of the investment company's stock and even where

ultimate control is in the hands of others. The adviser's controlling influence over his advisee does not stem from stock ownership. It stems from the fact that he manages the advisee's affairs and is normally the only audible voice in its management.

An investment adviser is an independent contractor. Hence his position with the advisee is not an "official position" for purposes of Section 2(a)(9) of the Investment Company Act.

Evidence

Standard of Proof

A preponderance of the evidence is sufficient to establish the truth of an allegation in an administrative proceeding under the federal securities statutes.

Public Interest

Dominant Individuals and their Corporate Instrumentalities

Corporate Respondents with Innocent Non-voting Shareholders

Sanctions -- Withholding of

Jurisdiction -- Reservation of

Where an investment advisory organization's misconduct was extremely serious, held, organization's controlling person and sole voting shareholder barred from association with any investment adviser, permanently prohibited from any association with any registered investment company in any of the capacities enumerated in Section 9(b) of the Investment Company Act, and suspended for 12 months from association with any broker or dealer. But sanctions on the corporate respondents controlled by that person, withheld, in the Commission's discretion because of the lack of any pressing need for such sanctions, because corporate respondents had innocent non-voting shareholders, because putting the corporate respondents out of business at once would leave the controlling person with nothing to sell which would be inconsistent with the Commission's decision to give the individual wrongdoer an opportunity to dispose of his interest, and because Commission wished to give corporate respondents an adequate opportunity to liberate themselves from the wrongdoer's controlling influence.

But jurisdiction reserved to impose appropriate sanctions on corporate respondents, should they fail to make required showing of liberation within the 90 days allotted for that purpose.

Breach of Fiduciary Duty Involving Personal Misconduct -- Cognizability of in Administrative Proceedings

Section 36(a) of the Investment Company Act Construed

Section 36(a) of the Investment Company Act is a grant of jurisdiction to the federal courts. Hence that section cannot serve as the sole basis for an administrative proceeding. But that section is pertinent to the assessment of sanctions in administrative proceedings otherwise properly before the Commission.

Where the record in an administrative proceeding with respect to an investment company manager showed that he had willfully violated significant substantive provisions of the securities statutes and also showed that those willful violations entailed breaches of "fiduciary duty involving personal misconduct," held, the breach of duty element is germane in fixing the quantum of remedial action.

Bar Orders

Disqualifications

Orders of Permanent Prohibition under Section 9(b) of the Investment Company Act

Stays

Bar orders normally become effective on issuance. But when appeals to the Court of Appeals are taken or about to be taken, the Commission gives stays of sufficient duration to permit applications for further stays to the Court of Appeals.

Where a bar order issued against the operating head of an investment company management organization, held, effectiveness of bar stayed for 90 days to give investment companies' directors adequate opportunity to make appropriate arrangements for the companies' future and to give the barred individual an opportunity to dispose of his controlling interest in the advisory organization.

The Commission always retains control over its own orders. Inherent in the power to impose

disqualifications is the power to lift or modify those disqualifications.

Constitutional Law

Ex-Post-Facto Laws

Statutory Construction

Changes in Remedies -- Retrospective Application of Continuing Wrongs

Section 9(b) of the Investment Company Act Construed

Section 203(f) of the Investment Advisers Act Construed

Remedies added to the Investment Company and Investment Advisers Act by amendments to those statutes that become effective on December 14, 1970, held, available in a case involving misconduct some of which occurred before that date because the statutory changes in question went solely to matters of remedy and had no bearing on legal rights or legal duties and because much of the misconduct occurred after the amendments had become law.

Constitution's ban on ex-post-facto laws, held, inapplicable to the retrospective application of tests of fitness in licensing statutes.

APPEARANCES:

Peter J. Nickles, of Covington & Burling, for respondents.

Vernon J. Vander Weide and Michael A. Starr, of the Washington Regional Office, for the Division of Enforcement of the Commission.

James C. Meers, of Corcoran, Youngman & Rowe, for certain investment company directors.

David Silver and Matthew P. Fink, for the Investment Company Institute.

I. INTRODUCTION

Charles W. Steadman, an investment company manager, and five corporations that he heads 1/ appeal from an administrative law

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1/ All five are registered with us. Some are registered as investment advisers. Others are registered as brokers and dealers.

judge's initial decision adverse to them. 2/ The principal corporate respondent is Steadman Security Corporation ("SSC"). Steadman owns all of SSC's voting stock. And SSC owns all of the stock of the other corporate respondents. Through SSC and SSC's subsidiaries, Steadman manages a group of mutual funds. During the relevant period, that group consisted of:

Steadman American Industry Fund, Inc.
Steadman Science and Growth Fund, Inc.

2/ Our Division of Enforcement is satisfied in the main with the initial decision. However, it too appeals. Its appeal brings up for review the correctness of the administrative law judge's refusal to make some of the findings of violation for which the Division asks. Leave to be heard was granted to certain directors of the Steadman-managed investment companies. Such leave was also granted to the Investment Company Institute. Briefs were filed, and oral argument heard. Our findings are based on an independent review of the record.

Steadman Fiduciary Investment
Fund, Inc.
Consumers Investment Fund, Inc.
Associated Fund Trust
Aberdeen Fund

The size of the asset pool under Steadman's management grew dramatically during the 1960's. At its height Steadman's investment advisory organization had some $250 million under management. Much of this growth came from acquisitions. Other investment advisers were bought up. The requisite capital was raised in the main by borrowing from commercial banks. The banks from which Steadman and SSC borrowed were also the banks in which the Steadman-managed funds kept their cash.

These complex and protracted proceedings present many issues. We begin with those that arise out of the banking relationships to which we have just referred.

II. BANKING RELATIONSHIPS

By reason of his predominant role in the management of the funds, Steadman was in a position to choose the banks in which they kept their

cash and to determine the amounts that would be kept on deposit in checking accounts that paid no interest. 3/

3/ Section 17(f) of the Investment Company Act requires an investment company of the management type to place its securities and similar investments in the custody of a bank, a stock exchange member or itself. If a bank is selected as custodian, the present law requires the investment company to keep all its cash assets in such bank (subject to certain exceptions). Although not required during the period relevant to this case, it was Steadman's practice to keep the funds' cash assets in the custodian bank. This practice had been recommended in our report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess., 336 (1966). The terms "cash assets" includes, for example, the proceeds from the sale of portfolio securities, interest and dividends derived from portfolio securities and any judgments realized by the investment company. Checking accounts are used principally for dividend distributions to fund shareholders, redemptions, and current expenses.

Starting in December 1965, Steadman and SSC began borrowing from the Washington bank in which the Steadman Funds then kept their checking accounts. By mid-1968, Steadman himself owed that bank over $1 million, and SSC, although it had repaid its loans, had borrowed up to $200,000. During those two and a half years, Steadman asked the bank to direct at least $50,000 of that bank's portfolio brokerage business to SSC's broker-dealer subsidiary, Republic Securities Corporation. And Republic, a relatively small, unseasoned firm, actually got $25,000 a year in brokerage from the bank.

To expand the pool of assets under his management, Steadman arranged to have SSC buy two more investment advisory organizations. To finance these purchases, he asked the bank to lend SSC $2 million on an unsecured basis. But it turned him down, finding inadequate assurance that SSC, whose operations had thus far been unprofitable, would be able to repay. Only after retaining two prominent investment bankers to locate a receptive bank did Steadman find a New York bank willing to grant SSC the loan.

At about the time that the loan was agreed to, Steadman and SSC recommended to the directors of the three mutual funds for which SSC was investment adviser that those funds transfer their bank accounts to the New York bank which was lending the money. The directors were told that the New York bank's custodial fees were lower than those of the Washington bank. The services that the New York bank was capable of supplying were also lauded. But no mention of the loans was made. The funds' boards knew nothing at all about them when they approved the transfer. 4/

Bereft of the funds' accounts, the Washington bank called its loans to Steadman. Steadman succeeded in getting a second Washington bank to lend him enough to repay the first. But by 1970, the market value of the collateral securing that loan had fallen materially. So this second Washington bank called its loan. Steadman got a 90-day extension. Two days later,

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4/ When Steadman moved his banking business to New York, he asked the bank there to give Republic some brokerage to make up for the lost income from the Washington bank. But the New York bank gave Republic very little business.

one of the funds bought a 90-day certificate of deposit from that bank in an amount in excess of the loan.

Faced with the need to repay the second bank's loan at the end of 90 days, and also confronted by problems in meeting SSC's obligations on the larger loan from the New York bank, Steadman and SSC sought out yet another Washington bank which would lend them enough to cover both loans, that is, over $4 million. All they got was enough to pay off the loan from the second Washington bank. Shortly thereafter, this third Washington bank received the account of a Steadman-managed fund whose account had been in St. Louis. Again, that fund's board was not told about the loan when it approved the transfer. 5/

Steadman said nothing about his or SSC's loans in any of the materials sent to the funds' actual or prospective shareholders. Nor did any report filed with us even hint

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5/ A week before the board met, Steadman whote to the St. Louis bank requesting it to waive its notice period and to send its records to the designated Washington bank.

at the loans. Yet it would, we think, have been obvious to anyone (let alone someone with Steadman's extensive legal and financial experience 6/) that the banking relationships were of considerable moment to anyone trying to formulate rational decisions about the investment merits of the Steadman-managed funds. 7/

6/ Steadman was trained as a lawyer and practiced law for some years. The administrative law judge said in his initial decision that "Steadman, a lawyer, should have been particularly aware of the duties and responsibilities of a fiduciary."

7/ The administrative law judge's observations quoted in the preceding footnote about the effect that Steadman's legal knowledge should have had on his sensitivity to fiduciary duties applies a fortiori to the effect that his experience at the bar must have had on his awareness of the disclosure obligations that the federal securities laws impose on issuers and underwriters. Any lawyer whose involvement with financial matters is as intimate and

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Steadman had a self-interest in cultivating and mollifying the banks from which he

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(7 Continued)

> as long as Steadman's was knows how rigorous those obligations are. Moreover, Steadman must or at the very least should have realized that he could not find shelter from that rigor under the umbrella of privacy. Well before the first of the loans here in issue was made we had held in an unusually well-publicized stop order case that "We cannot agree ... that disclosure of Glickman's borrowings and pledges ... would have been an 'unwarranted revelation' of Glickman's personal affairs. An insider of a corporation that is asking the public for funds must, in return, relinquish various areas of privacy with respect to his financial affairs which impinge significantly upon the affairs of the company. That determination was made by the Congress over 30 years ago when it expressly provided in the Securities Act for disclosure of such matters as remuneration of insiders and the

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borrowed. That self-interest led him to keep unduly large sums unnecessarily idle in checking accounts to the banks' benefit but to the funds' detriment. Whether this actually happened or not is unimportant. The heart of the matter is that Steadman had disabled himself from looking at the funds' checking account balances in a wholly disinterested way, with an eye single to the funds' best interests. 8/

(7 Continued)

extent of their shareholdings in and the nature of their other material transactions with the company." Franchard Corporation, 42 S.E.C. 163, 174 (1964). To this passage a footnote citation (n. 29) to "Schedule A to the Securities Act, Paragraphs 14, 18-20, 24-25" was appended.

8/ The order for proceedings does not charge that the bank balances were excessive. Hence we do not find that they were. But we note that the balances were substantial. The unproductive balances in the New York bank at times exceeded $9 million.

Investors had a right to know this. So Steadman had a duty to reveal his collateral banking relationships, which were such that a reasonable investor or prospective investor could reasonably have drawn adverse inferences about the character of the funds' management. 9/

9/ As we said in Franchard Corporation, 42 S.E.C. 163, 169-170 (1964):

> "Of cardinal importance in any business is the quality of its management. Disclosures relevant to an evaluation of management are particularly pertinent where, as in this case, securities are sold largely on the personal reputation of a company's controlling person. The disclosures in these respects were materially deficient ....
>
> "Evaluation of the quality of management--to whatever extent it is possible--is an essential ingredient of

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Those interested in mutual fund investment have hundreds of funds to choose from.

(9 Continued)

> informed investment decision. A need so important cannot be ignored, and in a variety of ways the disclosure requirements of the Securities Act furnish factual information to fill this need .... To permit judgments whether the corporation's affairs are likely to be conducted in the interest of public shareholders, the registration requirements elicit information as to the interests of insiders which may conflict with their duty of loyalty to the corporation."

These observations are especially pertinent where purely financial institutions,

so-called financial intermediaries, are involved. See Clark, The Soundness of Financial Institutions, 86 Yale L. J. 1, 73 (1976): "Management ... integrity may be ... crucially relevant."

Thus they need data enabling them to make an informed assessment of the comparative merits of the products offered by a host of competing investment advisers. 10/

10/ Some think that a mutual fund is essentially the brand name under which an investment adviser sells its services to the public. See Lobell, Rights and Responsibilities in the Mutual Fund, 70 Yale L. J. 1258 (1961); Lobell, The Mutual Fund: A Structural Analysis, 47 Va. L. Rev. 181 (1961). Though we consider this so-called "shell theory" an incomplete guide to public policy (see our 1966 report to the Congress on the Public Policy Implications of Investment Company Growth (House Report No. 2337, 89th Cong., 2d Sess.) at pp. 75-76), it is by no means entirely fallacious. Indeed, it is

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Steadman's prospectuses and reports concealed important data of that kind. It follows that those prospectuses and those reports were materially deceptive. 11/

(10 Continued)

quite realistic. One who buys mutual fund shares is buying professional investment management. What could be more important to such a person than information that helps him appraise the extent to which a particular manager has enmeshed himself in conflicts of interest that competing managers have avoided? See Tannenbaum v. Zeller, 552 F.2d 402 (C.A. 2, 1977): "A mutual fund is a mere 'shell,' a pool of assets that belongs to the individual investors holding shares in the fund. The management of this asset pool is largely in the hands of an investment adviser, which generally originates the fund .... The adviser ... operates or supervises.

11/ Adequate prospectuses would not only have described the relationships, but called

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Accordingly, we find, as did the administrative law judge, that Steadman, SSC and

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(11 Continued)

> attention to the bearing that they might have on the funds' cash management policy. That is so because a Securities Act prospectus must make the essential facts clear to the ordinary investor. See Universal Camera Corporation, 19 S.E.C. 648, 652 (1945). This means that those facts must be presented in such form as to make their significance readily ascertainable." Franchard Corporation, 42 S.E.C. 163, 184 (1964). Proper prospectuses would have led at least some investors to take a critical look at the size of the funds' non-interest bearing bank balances, to wonder about the wisdom of paying sales loads (though the Steadman funds are now no-load, they were sold through dealers on a load basis during the relevant period) and management fees for the privilege of keeping substantial sums idle in checking accounts, and to consider other mutual funds that put their

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Republic, during the period from December 1965 to February 1972, willfully violated

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(11 Continued)

cash balances to productive use by placing them in treasury bills and other money market instruments.

Acceptable proxy-soliciting materials would have had the same effect. True, those materials were addressed to existing shareholders. And it is also true that given the realities of the power relationships in most mutual funds, it is improbable (though not impossible) that proper disclosure in the proxy-soliciting materials would have led to Steadman's ouster by a shareholder vote. Such things happen. But they happen rarely. What happens often, however, is a wave of shareholder redemptions evoked by widespread dissatisfaction. That would have mattered to Steadman. His organization's advisory fees, like those of most other investment advisors, were based on the amounts managed.

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and willfully aided and abetted violations of the antifraud provisions of the Securities, Securities Exchange, and Investment

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(11 Continued)

Secondly, adequate disclosure to the existing shareholders could have led some of them to institute derivative or class actions against the management. Such actions would have been predicated on the premise that the banking relationships were a breach of fiduciary duty. We need not and do not decide whether such actions (some of which are now pending, have been touched off, we surmise, by the initiation of these public proceedings) would have resulted in judgments for the plaintiffs. What matters for present purposes is that such cases could have been filed and that, if filed, they could scarcely be shrugged off as frivolous. One of the key aims of the disclosure provisions of the statutes we administer is to alert investors to facts indicating that they or their corporations may have valid claims against management

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Advisers Acts. 12/ We further find that Steadman and SSC willfully violated or willfully aided and abetted violations by others of the Investment Company Act's reporting and proxy-solicitation provisions. 13/

(11 Continued)

and to facilitate the prosecution of such causes of action. See Mutual Benefit Realty Fund, Securities Exchange Act Release No. 12195 (March 14, 1976), 9 SEC Docket 149, 151 n. 14. See also n. 25, infra.

12/ Section 17(a) of the Securities Act; Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and Sections 206(1) and (2) of the Investment Advisers Act.

13/ With regard to proxy solicitations, Section 20(a) of the Investment Company Act and Rule 20a-1 thereunder prohibit any person from soliciting or permitting the use of his name to solicit any proxy with respect to any security issued by a

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Respondents maintain that the funds' bank accounts were wholly unrelated to the loans and

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(13 Continued)

registered investment company unless in compliance with not only Rules 20a-2 and 20a-3, but also all rules adopted pursuant to Section 14(a) of the Exchange Act. Rule 20a-3 requires the description of "any material proposed transactions, to which the investment adviser of the investment company or any ... subsidiary of the investment adviser was or is to be a party." And Rule 14a-9 under the Exchange Act makes it unlawful to solicit proxies with proxy materials which contain material misstatements or omissions, which is what the funds did. Similar prohibitions are contained in Section 34(b) of the Investment Company Act for reports filed or transmitted pursuant to that Act. And the funds' annual reports on Form N-1R and quarterly reports on Form N-1Q failed to make these material disclosures, as also required by Rules 30a-2 and 30b1-1 for reports filed pursuant to Section 30 of the Investment Company Act and Sections 13 and 15(d) of the Exchange Act.

the brokerage business that went to Steadman and his investment advisory organization. Taking vehement exception to the administrative law judge's finding that Steadman was continually bargaining for loans by holding out the funds' checking accounts as a quid pro quo, they contend that the record shows only a series of coincidences that involved one bank after another and that went on for year after year.

We need not and do not pass on the precise nature of the relationship between the funds' deposits and the benefits that Steadman obtained from the banks 14/ in which those deposits were kept. 15/

14/ Consequently, we need not pass upon respondents' contention that the administrative law judge improperly extracted from the documentary evidence statements showing that when the loans were sought, not only from the banks which granted them but from several which declined, references were made to the funds' deposits.

15/ But it is hard to believe that there was no link at all between the funds' deposits and

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Whether the banking relationships were or were not corrupt is beside the point for present purposes. What matters is that reasonable investors could reasonably have deemed those relationships "corrupting." 16/ And that is what brings the antifraud provisions to bear on the affair.

(15 Continued)

the benefits to Steadman. We note in this regard that save for one case in which special circumstances deprived Steadman of the power to disrupt a historic banking relationship that he had inherited from the fund's previous adviser, Steadman always saw to it that the funds kept their cash in banks that lent him money.

16/ Cf. Mr. Justice Jackson's opinion in Mosser v. Darrow, 341 U.S. 267, 271 (1961), where he spoke for the Court and observed: "Equity tolerates in bankruptcy trustees no interest adverse to the trust. That is not because such interests are always corrupt but because they are always corrupting."

Steadman himself may have believed that his actions were proper, and did the funds no harm. He also may not have planned to cause the funds to keep cash unnecessarily idle in checking accounts, rather than investing it for the funds' benefit.

But Steadman had a duty to disclose the facts that investors and their advisers needed in order to arrive at their own informed judgments about:

(A) The investment significance of his relationships with the banks in which the funds' cash was kept; and

(B) The implications of those relationships in assessing the quality and the integrity of his management.

We conclude that Steadman's long continued practice of borrowing heavily from the very same commercial banks in which he caused the funds to keep large sums on deposit had a potential for subordinating the funds' interests to Steadman's need for bank loans. Hence the subject was of sufficient moment to create "a substantial likelihood that a reasonable shareholder would consider it

important" in making his decision. 17/ Accordingly, we hold the undisclosed banking relationships "material."

The collateral banking relationships were among the intricacies attendant on an investment in a Steadman-managed fund. And the central purpose of the disclosure provisions of the securities statutes is to give investors "the means of understanding the intricacies of the transaction into which they are invited." 18/

It follows that Steadman was under a duty to bring the "complex of circumstances ... to [the

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17/ TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

18/ The quotation is from the House report on the bill that eventually became the Securities Act. H.R. Rep. No. 85, 73d Cong., 1st Sess. 8 (1933). And as we observed of this quotation in another case not long ago, "The thought illumines the Exchange Act as well." Multi-Benefit Realty Fund, Securities Exchange Act Release No. 12195 (March 11, 1976), 9 SEC Docket 149, 154 n. 26.

investor's] attention lucidly and forcefully." 19/

True, such breaches must be found "willful" before we can take cognizance of them in a proceeding of this character. But this does not mean that those subject to our administrative disciplinary jurisdiction can immunize themselves from its impact by substituting their own notions about disclosure for those adopted by the Congress and applied by the courts. 20/ As the Court of Appeals for the Second Circuit observed in Tager v. S.E.C. 21/ and again in Lipper v. S.E.C. 22/:

19/ Franchard Corporation, 42 S.E.C. 163, 181 (1964).

20/ See 2 Loss, Securities Regulation 1309 (2d ed. 1961); 5 id. 3368-3374 (1969 supp.).

21/ 344 F.2d 5 (1965), affirming our decision in Sidney Tager, 42 S.E.C. 132 (1964).

22/ 547 F.2d 171 (C.A. 2, 1976), affirming our decision in Arthur Lipper Corporation, Securities Exchange Act Release No. 11773 (October 24, 1975), 8 SEC Docket 273, but modifying the sanctions on the two respondents that appealed.

> "It has uniformly been held that 'willfully' in this context means intentionally committing the act which constitutes the violation. There is no requirement that the actor also be aware that he is violating one of the Rules or Acts." 23/

Respondents tell us that all this is now mere history. They say that the Supreme Court's decision of March 30, 1976, in Ernst & Ernst v. Hochfelder 24/ laid down a new rule under which no adverse findings can be made against them under any of the antifraud sections because there is no evidence that they intended to deceive. 25/

23/ 344 F.2d at 8, quoted with approval in 547 F.2d at 180.

24/ 425 U.S. 185.

25/ Our staff, on the other hand, maintains not only that intent to deceive is irrelevant, but that deception itself is irrelevant. In its view, the collateral banking relationships would have run afoul of the antifraud provisions even if disclosed. It

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But Hochfelder was a private action for money damages. The plaintiffs were seeking to recover for negligent nonfeasance. Their allegations amounted at most to a claim that the defendant, an accounting firm that never made any representations to them and with whom they were never in privity, had carelessly aided and abetted someone else's violation of the securities laws. Thus the question presented was "whether a private cause of action for damages will lie under § 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter' -- intent to deceive, manipulate or defraud." 26/ The Court concluded

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(25 Continued)

> reasons that there was so egregious a breach of fiduciary duty here that Steadman could no more cure his trafficking in the funds' deposits by making a clean breast of it than an embezzler can cure his embezzlement by disclosing it. The administrative law judge took this view. We eschew such speculations. Had the banking relationships been disclosed, an altogether different case would be presented. That case is not before us. And we do not decide it.

26/ 425 U.S. at 193.

that it could not. And since the plaintiffs "had proceeded on a theory of liability premised on negligence, specifically disclaiming that Ernst & Ernst had engaged in fraud or intentional misconduct," 27/ their complaint was dismissed. 28/

27/ Id. at 215.

28/ In their search for pecuniary redress, Ms. Hochfelder and her co-plaintiffs focused on a deep pocket at the outermost fringes of the scene. The plaintiffs conceded that they had not in fact relied on what the defendant did. Nor were the plaintiffs within the class to whom the defendant owed a common law duty of due care. 425 U.S. at 192, n. 9. Hence even in a private action founded solely on Rule 10b-5, the Hochfelder rule would not necessarily preclude a claim against someone like Steadman who far from being a peripheral actor was at the very center of a complex web of investment companies, investment advisers and principal underwriters, was a fiduciary for those investment companies and for their shareholders, was subject to

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The instant case does not resemble Hochfelder. This is not a private action for money damages. It is a proceeding initiated by a public authority for the prophylactic purpose of preventing future harm to the public interest. 29/ Nor

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(28 Continued)

affirmative disclosure duties imposed by federal statute, and who would even at common law have been deemed subject to a far higher standard of care than that incumbent on an ordinary businessman. See Hun v. Cary, 82 N.Y. 65 (1880); Medford Trust Co. v. McKnight, 292 Mass. 1, 197 N.E. 649 (1955). The Supreme Court's view seems in accord. Santa Fe Industries, Inc. v. Green, ___ U.S. ___, 97 S.Ct. 1292, 1299 n. 11 91977).

29/ Cf. n. 12 to the Hochfelder opinion: "Since this case concerns an action for damages, we need not consider whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5."

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does this case rest solely on Rule 10b-5. 30/ Indeed, it does not turn on 10b-5 at all. 31/

(29 Continued)

We are not unmindful of the Second Circuit's suggestion in Lipper v. S.E.C., 547 F.2d 171, 180-81 n. 6 (C.A. 2, 1976), that disciplinary proceedings may be more akin to actions for damages than to those for injunctive relief. But it did not decide "that the Hochfelder culpability standard applies in disciplinary proceedings." All that it did was to "assume, arguendo," that Hochfelder governs such proceedings. And, in any event, Lipper's formulation of willfulness (see 547 F.2d at 181) would be more than adequately met here.

30/ Section 17(a) of the Securities Act and the provisions of the Investment Company Act cited in n. 13, supra, are independent bases for liability.

31/ Section 17(a) of the Securities Act, which has been in effect since 1933,

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The references to that rule in the order for

(31 Continued)

makes it unlawful "(2) to obtain property by means of any untrue statement of a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; (3) to engage in any transaction, practice or course of business which operates as a deceit upon the purchaser." In Hochfelder the Supreme Court pointed to the absence of similar language in Section 10(b) of the Securities Exchange Act, as distinguished from Rule 10b-5. The Court viewed this lack as a significant guide to 10b-5's scope. 425 U.S. at 214.

We note in this regard that a contemporaneous comment on Section 17 states that it "makes unlawful even innocent acts to obtain money or property by means of untrue statements of material facts or omissions to state material facts." Douglas and Bates, The Federal Secutities Act of 1933, 43 Yale

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proceedings and in this opinion are merely cumulative. 32/

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31 Continued/

L. J. 171, 181 (1933). See S.E.C. v. Van Horn, 371 F.2d 181, 185 (C.A. 7, 1966): "In view of the plain language employed by Congress, it would be presumptuous on our part to hold that the applicability of the clauses involved [Section 17(a)(2) and Section 17(a)(3) of the Securities Act] is dependent on intent to defraud." Hence Hochfelder has no bearing on cases brought under Section 17(a) of the Securities Act. S.E.C. v. World Radio Mission, Inc., 544 F.2d 535, 541 n. 10 (C.A. 1, 1976).

32/ Compare Crow, Brourman & Chatkin, Inc., 42 S.E.C. 938, 945 (1966): "[T]he violations found with respect to these provisions may be viewed as cumulative."

More could be said about our view of Hochfelder. But that is unnecessary. 33/ Respondents gain nothing from Hochfelder because the Hochfelder standard has been met.

What we have here is:

(1) a duty to reveal; plus

(2) an intent to conceal; and

(3) actual concealment.

This is not a "negligence" case. There was no accident, no monetary slip, no failure to act reasonably under stress. These were no ordinary commercial loans. They were large in amount and semi-permanent in duration. Borrowing from the banks in which his funds kept their cash was a way of life for Steadman. It was basic to his modus operandi. So he could scarcely have forgotten these banking relationships.

33/ However, we think it appropriate to note that we do not construe Hochfelder as altering the rule laid down in Hanly v. S.E.C., 415 F.2d 589, 597 (C.A. 2, 1969) that" ... proof of specific intent to defraud ... is irrelevant in broker-dealer proceedings."

Steadman did not choose to testify. Hence his state of mind must be inferred from the circumstances. 34/ And the pertinent circumstances are these:

(1) He concealed the loans from the funds' directors and did not disclose them to investors.

(2) He did so for many years.

(3) Though he claims to have relied on the advice of counsel with respect to other

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34/ That would probably be so even if he had testified. As we said in The Federal Corporation, 25 S.E.C. 227, 230 (1947):

> "Since it is impossible to probe into the depths of a man's mind, it is necessary in the usual case (that is, absent an admission) that the finding ... be based on inferences drawn from circumstantial evidence." Cf. Lawrence H. Ripp, Securities Exchange Act Release No. 13198 (January 24, 1977), 11 SEC Docket 1555, 1556.

matters, he makes no such claim with respect to his banking relationships. 35/

Accordingly, we find that Steadman and his corporate instrumentalities intended to deceive. Moreover, we agree with the respondents that intent is relevant here. That is so not because we consider intent pertinent to the willful violation issue, but because we deem it highly germane to determining the quantum of the remedial action, if any, that due regard for the public interest requires us to take.

Steadman's systematic, calculated and protracted concealment of his collateral banking relationships is enough in itself to brand him an unfit manager of other people's money. Even if there were nothing to this case but the undisclosed collateral banking relationships, we should be

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35/ Such reliance would not negate the willful violations. But it is often of great mitigative weight. Steadman is a lawyer himself. So he may have relied on his own view of what the law was. If he did that, he must have realized that he was going close to the line and assuming serious juridical risks.

constrained to bar Steadman from both the investment company and the investment advisory businesses.

III. THE BANKING RELATIONSHIPS -- REGULATORY ASPECTS

Our staff maintains that there is much more to the banking relationships than the mere failure to disclose them. 36/ It says that those relationships were flatly prohibited by the Investment Company Act. Three sections of that statute are invoked. They are:

(1) Section 15(a)(1) of the Investment Company Act, which makes it "unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which ... precisely describes all compensation to be paid thereunder" (emphasis added);

36/ We have already touched on one of its contentions in this area. See n. 25, supra.

(2) Section 17(d), which together with our Rule 17d-1 thereunder, requires that "joint participations" between investment companies and their affiliated persons be first scrutinized by us "for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than such other participant"; 37/ and

(3) Section 17(e)(1), which provides that "It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person--acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker." (Emphasis added.)

For Section 15(a)(1)'s purposes, the loans to Steadman and to SSC were "compensation"

37/ The quotation is from the statute.

to them. 38/ And the brokerage business that the banks gave Republic at Steadman's

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38/ Respondents argue that the loans were "standard commercial loans made at prevailing interest rates in accordance with standard banking practices." They contend that such loans are not "compensation" to the borrower. In support of their position they cite Imperial Financial Services, Inc., 42 S.E.C. 717, 728 n. 16 (1965). They say that the loans gave them nothing but the duty to repay them with interest.

We disagree. Loans are of economic benefit to those who receive them. Hence they are "compensation." Our 1965 Imperial decision is not to the contrary. All that the Commission held there was that a loan at 7% interest back in 1960 (when interest rates were low and 7% was an extremely generous rate) was a "less clear instance of the receipt of compensation" than another loan involved in that case which bore no interest at all. The Commission did not hold that the 7% loan was not "compensation." It

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instance was "compensation" to it, to its parent SSC, and to Steadman himself. 39/ But it does not follow that this was the type of compensation that had to be spelled out in the advisory contracts.

(38 Continued)

simply said, "[W]e make no finding with respect to this transaction." In our view that was simply a determination that it was unnecessary or inappropriate to reach the question on the record that the Commission had before it in Imperial (a case that was settled and in which the record consisted of a stipulation) and not as a holding that an interest-bearing loan can never be deemed "compensation."

39/ Respondents point out that the commissions "were earned in the course of ... business as a broker for the banks and ... paid for services actually rendered in executing ... purchase/sale transactions." We agree. But we do not see how that deprives those commissions of their compensatory character.

Section 15(a)(1)'s command goes only to the "compensation to be paid thereunder." The word "thereunder" is significant. We think that it means that the only compensation that counts for that purpose is compensation paid directly or indirectly by the investment company itself. When the authors of the Act wanted to reach "any compensation" "from any source," they said so. 40/

Accordingly, we hold that the Act did not mandate references to the collateral banking relationships in the advisory contracts. 41/

Section 17(d) and Rule 17d-1 thereunder present closer questions. Section 17(d) extends to "any transaction" in which a registered investment company "is a joint or a joint and several participant" with any of its affiliated persons, any affiliated person of such an affiliated person, any of its principal underwriters, or any

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40/ Section 17(e)(1).

41/ It does not follow that such references would have been improper or inappropriate. Their inclusion might well have been desirable.

affiliated person of any of its principal underwriters.

The key phrases in this subsection are "any transaction" and "a joint or a joint and several participant." The generality of this language, together with the paucity of judicial decisions construing it, has led to considerable uncertainty as to its exact scope. The parties' positions are far apart.

The Investment Company Institute would require that there be a joint venture between the investment company and the affiliate in pursuit of profit. This is too narrow a construction. Section 17(d) refers to a participant in a joint venture and to participation which is either "joint" or "joint and several." The joint venture concept is well known in the law. Had Congress intended to limit the reach of Section 17(d) to that concept, it would have said so.

As the Court of Appeals for the Second Circuit said in S.E.C. v. Talley Industries, Inc., 42/

42/ 399 F.2d 396 (1968), cert. denied, 393 U.S. 1015 (1969).

the leading case under Section 17(d) -- although not in point here on its facts:

> "[A]ny idea that § 17(d) is limited to the typical joint venture in which each of the parties has a fractional share is negated by the point that its very life is to limit or prevent participation by the investment company 'on a basis different from or less advantageous than that' of the affiliated person." 43/

The staff, on the other hand, would give Section 17(d) a very broad construction reaching most economic relationships in which an investment company is on one side and one of its affiliates is on the other. That would make a number of the Act's other provisions redundant. 44/ We are reluctant to adopt an interpretation so broad. That is so even though "transaction" is undoubtedly a broad term. As the Court of

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43/ 399 F.2d at 402.

44/ Sections 17(a) and 17(e) would probably be among those sections.

Appeals for the Second Circuit noted in Talley, "transaction" may mean "To prosecute negotiations; to carry on business; to have dealings ***." 45/

The concept of a "joint or joint and several" transaction is unusual. 46/ Applying the Talley principle that "some element of combination is required" 47/ but that a "loose kind of combination" may be sufficient on the basis of a liberal construction of the Act, 48/ three party

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45/ 399 F.2d at 402, quoting Webster's New International Dictionary (2d ed.) 2688.

46/ Resort to the law disctionaries is not overly helpful. According to Black's Law Dictionary (4th ed. 1968) and Ballantine's Law Dictionary (3rd ed. 1969), "several" means, essentially, "not joint." Joint and several is a procedural term, applicable primarily to contracts, and means in substance that a creditor acquires the option to sue his debtors individually or as a group.

47/ 399 F.2d at 403.

48/ Ibid.

transactions, such as those present here, would seem within Section 17(d)'s scope were there a causal connection between the funds' deposits and Steadman's loans. If the loans were a "quid pro quo" for the deposits, or the deposits a "quid pro quo" for the loans, the "combination" referred to in the Talley decision would be present. 49/ The funds would be "participants" because the use of their assets would have been so significant a part of the total transaction.

In the previous section we observed that "Steadman always saw to it that the funds kept their cash

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49/ This is not to imply that such a causal connection is necessary in every Section 17(d) case. It is necessary in the present case because without the participation of the banks there would be no joint transaction between the funds and Steadman. By way of contrast, for example, in the Talley case the joint transaction was the purchases of General Time Corporation shares by Talley Industries, Inc. and its affiliate, American Investors Fund, Inc. In that situation it was not necessary for the sellers of such shares to know that Talley and American Investors were in a joint transaction for there to be one.

in banks that lent him money" 50/ and that "this makes it hard to believe that there was no link at all between the funds' deposits and the benefits to Steadman." 51/ So it seems highly probable that the loans and the deposits were related to each other. 52/ Hence the administrative law judge inferred a causal connection. We find it hard to say that he erred when he did so. We have ourselves drawn comparable inferences 53/ in situations that seem analogous. 54/

50/ We noted that there was one exception, which involved a situation beyond Steadman's control.

51/ Note 15, supra.

52/ The contrary view leaves us with a most remarkable series of coincidences.

53/ See, e.g., C. Gilman Johnston, 42 S.E.C. 217, 219 (1964); Lawrence H. Ripp, Securities Exchange Act Release No. 13198 (January 24, 1977), 11 SEC Docket 1555, 1556.

54/ In this very case, we have already drawn one with respect to Steadman's state of mind. See text at n. 34, supra.

On this record, however, we are disinclined to infer the causality needed to bring Section 17(d) to bear on this situation. Much of the testimony is to the contrary. 55/

55/ Some of the bankers with whom Steadman dealt testified that in their minds there was no connection between the loans and the deposits. They claim to have viewed them as independent of each other. Their testimony is offset by papers that point to the opposite conclusion. However, the admissibility of those papers is challenged. So is their probative force. Finally, some of the very testimony on which the respondents rely can be read favorably to the Division. Some banker-witnesses distinguished the loans themselves from the interest rates that they bore. They insisted that the loans were unconnected to the deposits. But they conceded that balances on deposit normally affect interest rates. An important banker-witness characterized the determination of the interest rate as a "pricing decision" and testified that ample balances "would tend to lower the interest rate."

So questions of fact are raised. 56/ We do not reach them.

When the case is viewed as a whole, it becomes apparent that the causality issue is far from central. The issues we deem crucial relate to the respondents' duty to disclose. For reasons already stated, causality has no bearing on that. Hence we see no pressing need to resolve the factual questions on which the causality issue turns.

That precludes us from finding a causal nexus or a quid pro quo. Without this there is no basis for inferring a "combination." And absent some sort of "combination," however loose, adverse findings under Section 17(d) are unwarranted. Hence we make no such findings.

We come now to Section 17(e)(1). That prevented the respondents from accepting "from any source any compensation (other than a regular salary or wages ...) for the purchase or sale of any

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56/ With respect to the loans themselves, as distinguished from the interest rates that they bore, there is no live testimony that clearly supports the quid pro quo hypothesis.

property to or for" their investment company clients. If the loans and the brokerage business received from the banks were "compensation" to the recipients for purposes of Section 15(a)(1), 57/ they were also "compensation" to them for purposes of Section 17(e)(1). But (save for the certificate of deposit purchased from a Washington bank, 58/ which we put to one side for the moment), such "compensation" had no nexus with the purchase or sale of any investment company property.

That is obvious with respect to the brokerage commissions. They were generated by the banks' portfolio transactions. The investment companies' portfolios were uninvolved.

What of the checking account balances? Those were the funds' property. But that property was neither bought nor sold. Nothing was bought from the banks when deposits were made. Nor was anything sold to them when checks were

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57/ See note 38, supra.

58/ See text following note 4, supra.

written. What commercial banks sell to their demand depositors is services, not property. 59/

Certificates of deposit are different. They are not open book accounts but tangible choses in action. Banks sell them. And customers buy them. So the Steadman-managed fund that bought a 90-day certificate of deposit from a Washington bank purchased property from that bank.

However, it is not clear that the respondents received any illicit compensation for that purchase. It is true that Steadman owed this bank a large sum. And it is also true that his loan came due before the certificate was purchased. But the loan was extended before the certificate was purchased. The two transactions may well have been related to each other. But the record

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59/ Our staff argues that the funds' contractual rights to custodial services from the banks were "property." It also suggests that the custodial agreements involved the acquisition of space in the offices of the various banks for the safeguarding of securities and that the funds' interests in this space were their property. These contentions are ingenious but unpersuasive.

is not clear enough on this point to warrant an adverse finding. Accordingly, we find nothing in the banking phase of the case that violated Section 17(e)(1).

IV. ADVISORY FEES

The advisory agreements between SSC and two of the funds that it managed limited the advisory fee to 1% of the fund's average net assets. 60/ At the end of the fiscal year, it became apparent that the payments to SSC had exceeded that 1% maximum. 61/ So SSC owed the funds money. It

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60/ For a discussion of such limitations and their background, see Ellis, MutualFund Expense Limitations, 7 Review of Securities Regulation 932 (1974).

61/ In one case the year involved was the one that ended on June 30, 1970. In the other, the fiscal year closed on January 31, 1971. The overruns were caused by sharp declines in the value of the funds' assets. Those declines caused the aggregate advisory fee for the whole year to be appreciably lower than anticipated during the course of the year.

had a $155,000 obligation to one fund. And it owed the other $105,000.

SSC did not refund that $260,000 immediately. Instead it resorted to installments. These were paid monthly over time. Eventually, the entire $260,000 was returned to the funds with interest at 6% from the dates on which the funds' claims ripened.

The administrative law judge found that:

(A) SSC's duty to refund arose as soon as the year-end computations were made.

(B) SSC was unable or unwilling to discharge that duty promptly because it was in serious financial straits at the time.

(C) During the period that elapsed between the dates on which SSC became obligated to reimburse the funds and the date on which full reimbursement was finally made, SSC had the use of substantial sums that belonged to the funds.

These findings are clearly correct. And we adopt them as our own. The long and the short of the whole affair is that money that belonged to the funds and that they should have been

investing for their shareholders' benefit was in SSC's coffers and was used by SSC in its business.

Nothing in the advisory contracts between SSC and the two advisee-funds in question suggested that any benefits of this type would inure to SSC. In fact, such benefits did inure to SSC. It follows that:

(i) SSC received compensation from the two funds in question that, far from being described in the advisory contracts with the precision required by Section 15(a)(1) of the Investment Company Act, was left wholly unmentioned.

(ii) When it did that, SSC willfully violated Section 15(a)(1), which precludes "any person" from acting as investment adviser of a registered investment company pursuant to a contract that does not "precisely" describe "all compensation to be paid thereunder."

(iii) SSC's willful violations were willfully aided and abetted by Steadman himself, the prime mover in the whole affair. SSC's interest payments to the investment companies from which it obtained these extensions of credit do not

divest the transactions of their compensatory character.

The central fact is that SSC very much wanted to hold on to the money that it was supposed to return to the investment companies. The installment payment scheme originated with SSC, not with its investment company clients. We think it fairly clear that a debtor who is obligated to pay in full at once and who succeeds in inducing his creditor to accept a protracted installment schedule in lieu of the immediate full reimbursement to which the creditor is entitled reaps an economic benefit from the installment arrangement. Had SSC obtained the use of these monies without any interest at all, it would have received an outright gratuity from the investment companies. The interest payments gave the investment companies something of value in return for their forbearance. Nevertheless, that forbearance was of substantial economic benefit to SSC. Section 15(a)(1) required precise descriptions of such benefit in the advisory contracts. 62/

62/ The precise amounts of the advisory fee overpayments were, of course, unknown until the fiscal years in question had closed.

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Moreover, the 6% interest rate itself involved a detriment to the investment companies that received it and a correlative benefit to SSC. During the relevant period, the prime rate was in the neighborhood of 8%. 63/

So even if SSC's obligations had been of prime quality, it would have been getting a bargain rate of interest from its investment company clients.

(62 Continued)

Some months earlier, however, it became apparent that the year-end computations would probably show such overpayments. The record suggests that SSC realized at that early date that it would be inconvenient for it to pay in full at once. At that time it should have prepared the amendments to the advisory contracts that were needed in order to attain its objective. Those amendments should then have been submitted to special meetings of the affected investment companies' shareholders with appropriate disclosure.

63/ See Federal Reserve Bulletin, December 1970, pp. A-32, A-33.

Inherent in the statutory requirement that arrangements of this character be described in the advisory contracts with precision is the further requirement that they be accurately and adequately disclosed in the prospectuses of the affected investment companies and in their filings with us. The duty to make these disclosures was on Steadman and on his alter ego, SSC. Both of them breached that duty. 64/

We have not overlooked a controversy about the manner in which SSC computed its advisory fee. The administrative law judge found that the

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64/ We hold, as did the administrative law judge, that those breaches were in willful violation of Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act, Rule 10b-5 under the latter section, and Sections 206(1) and 206(2) of the Investment Advisers Act. We also affirm the administrative law judge's finding that Steadman and SSC willfully aided and abetted the affected funds' violations of Section 34(b) of the Investment Company Act, which makes it "unlawful for any person to make any untrue statement of a material fact in any ... document filed or transmitted pursuant to this title."

method of computation used inflated the fees. But the amounts involved appear immaterial. And the inflation was temporary.

V. TENDER SOLICITATION FEES

In 1969, tender offers were made for certain securities held by three Steadman funds. The offerors paid fees to soliciting brokers. Steadman had his broker-dealer alter ego, Republic, tender the funds' securities to the offerors, in return for which Republic received the solicitation fees. Those fees came to 2% of the value of the securities tendered. At first, Republic retained the entire 2%. Later, however, it decided that 2% was too much. So it gave half the fees to the tendering funds. The other half, i.e., 1% of the value of the securities, Republic kept. It reasoned that it was entitled to a 1% fee under Section 17(e)(2)(C) of the Investment Company Act, which permits a broker to collect a fee of up to 1% when "acting as broker" for an investment company with which he is affiliated. The question for decision is: Was Republic "acting as broker" in this situation?

The administrative law judge's answer was in Republic's favor. He thought that "Republic had

done the same things that an unaffiliated broker would have had to do had the task been assigned to it." Hence he found no violation of Section 17(e).

We cannot agree.

Where no brokerage is needed, no fee may be collected. These fees paid were to "soliciting brokers." Republic did no soliciting. It merely transmitted the tendered securities. No broker was needed for that. 65/

65/ Hence respondents' reliance on First Multifund of America, Inc., 44 S.E.C. 680 (1971), is misplaced. They are quite right when they say that the affiliated broker who was there permitted to retain brokerage compensation didn't work any harder than Republic did in this case. Neither case involved onerous chores. But the laboriousness of the task is not the test. Brokerage services may be and often are essentially clerical. Nevertheless, they may be needed. An affiliated broker who executes a registered investment company's order for 100 shares of American Telephone and Telegraph

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The decision to tender had already been made by the investment adviser. For making such

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> on the New York Stock Exchange does not have to strive mightily. Nevertheless, he is entitled to his commission. In First Multifund, a mutual fund was buying the shares of other mutual funds. The funds' shares, like those of Steadman's own funds during the relevant period, were sold only through independent broker-dealers. So anyone who wanted to buy those shares had to go to a broker. That is not so at all in the tender offer situation. No investor needs a broker in order to tender. The offeror is only too happy to take the securities directly from the holder. He saves money that way.
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> When an investment company is involved and when that investment company has an affiliated broker, that saving for the offeror is a loss to the investment company. Hence we have pointed out that "directors and managers of investment companies ...

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decisions it received an advisory fee. It could not pocket a second fee for the very same service by donning its broker-dealer hat. 66/ Accordingly, we find that Republic, willfully aided and

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65 Continued/

may have an obligation to name an affiliated broker to receive ... solicitation fees." So the interposition of Republic was quite proper, indeed laudable. But Republic's retention of the fees was patently improper. As the release from which we have just quoted said, "commissions or fees on the tender of portfolio securities should not be retained by the affiliate but should inure to the benefit of the fund." Securities Exchange Act Release No. 10102, Withdrawal of Proposed Amendment to Rule 10b-13 under the Securities Exchange Act of 1934 (April 12, 1973), 1 SEC Docket No. 11, page 17.

66/ Provident Management Corporation, 44 S.E.C. 442, 449 (1970), a case on all fours with the instant case, held this practice "an impermissible form of personal

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abetted by Steadman, willfully violated Section 17(e) of the Investment Company Act.

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enrichment." Respondents and the Investment Company Institute answer that Provident is not a true precedent because the case was uncontested and because the opinion was written in connection with an offer of settlement. That contention does not go to the validity of Provident's reasoning. We think that reasoning valid. And we now reaffirm what we said there.

Moreover, we think that Provident has been a precedent since its publication back in 1970. An order that simply accepts an offer of settlement without comment does not create a precedent.

But Provident was not such a case. There we issued "an opinion stating our views on the issues raised. Such opinions [citations omitted] are written only after deliberation and analysis akin to that reflected in our opinions in contested cases. Hence

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VI. LATE FILINGS

The administrative law judge found that "[t]hroughout the period 1968 through mid-1972 the various Steadman affiliates, including the registered Steadman Funds advised by SSC, repeatedly failed to file required reports within the prescribed time. In many instances the reports were filed so late as to be of minimal value in serving the purposes intended by the requirements for filing the reports." 67/

Under the management agreements between Steadman's management company and the funds, SSC was obligated "to maintain the books of the Fund ... and to supervise the Fund's relations with its custodian, auditors and federal and state regulatory bodies." This included the filing of the funds'

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they are as authoritative as opinions in those cases." Carl L. Shipley, Securities Exchange Act Release No. 10870, Investment Company Act Release No. 8394, Investment Advisers Act Release No. 419, p. 4 n. 6 (June 21, 1974), 4 SEC Docket 76, 479-480.

67/ No reports were filed during 1971.

annual reports. 68/ The annual reports of at least three funds were filed late for three consecutive years (1970, 1971, 1972). 69/ And the annual reports of Steadman's four broker-dealer firms 70/ were filed late in 1971 and 1972. 71/

68/ Section 30(a) of the Investment Company Act and Rules 30a-1 and 30a-2 thereunder require these reports.

69/ Reports were due in 1970, 1971 and 1972 for Fiduciary Fund and Aberdeen Fund on April 30 of each year, but their 1970 reports were not filed until September of that year, and those for 1971 and 1972 not until June 1972. American Fund's 1970 report, due May 31, was not filed until December, and its 1971 and 1972 reports not until June 1972. Similarly, Associated Fund's 1970 report, due January 28, was not filed until March 23, and its 1971 and 1972 reports not until June 1972.

70/ Section 17(a) of the Exchange Act and Rule 17a-5 thereunder require these reports.

71/ Reports for these firms were due on February 14 in 1971 and 1972, but were not filed until May 3, 1971 and June 19, 1972.

Respondents concede that the reports were late. 72/ They say, however, that those due in 1972 "were filed within a relatively short time after their due date," and that those due in 1973 "were all timely filed." These contentions do not go to the principal problem, the 1971 reports.

Those were more than a year late. Respondents seek to excuse these lengthy delays by pointing out that finding an adequate replacement for the funds' controller who resigned in 1971 took seven months; that the whole Steadman complex changed outside auditors during that year; and that requested extensions for the late broker-dealer filings were denied without explanation. These considerations in no way detract from the explicit requirements that reports be timely filed. The violations occurred. 73/

72/ No bookkeeping or recordkeeping violations are alleged.

73/ Hence Steadman willfully aided and abetted the funds' failure to file timely in violation of Section 30(a) of the Investment Company Act and

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Respondents' arguments seek to mitigate. But we find them unavailing.

Differing with respondents as to the cause of the delayed filings, the administrative law judge attributed them to Steadman's greater interest in expansion than attention to proper management of existing funds. 74/

(73 Continued)

Rules 30a-1 and 30a-2 thereunder. Moreover, the broker-dealers, willfully aided and abetted by Steadman, willfully violated Section 17(a) of the Exchange Act and Rule 17a-5 thereunder.

74/ He commented that "even when the need became painfully apparent, Steadman refused to expand SSC's managerial capability to manage properly the newly acquired Funds and the broker-dealers because the profitability of such acquisitions was predicated upon SSC's ability to manage the new Funds with little or no increase in SSC's personnel or other facilities."

He cited repeated advice given Steadman by his auditors that proper accounting functions were not being performed. 75/

And he cited a bank's termination of credit to Republic resulting from Republic's accounting problems.

SSC's personnel costs fell sharply in 1970. This suggests that Steadman was more concerned

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75/ It was these auditors who were replaced during 1971. But before that time they had advised Steadman that serious deficiencies existed in SSC's organization and capability to meet the increased responsibilities resulting from the expansion of the Steadman organization in 1967 and 1968. They pointed out that because of poor organization and inadequate personnel, daily accounting functions were not being performed, records were not being maintained, errors were going undetected, and report deadlines were being met with difficulty. They emphasized that this was a serious situation which might in the future require notice to regulatory agencies.

with keeping costs down than with maintaining the kind of an organization that was needed to do the job. Steadman chose to save money on essentials. The difficulties that this decision caused were self-created. So we do not see how those difficulties can possibly be deemed mitigative.

To file investment company annual reports more than a year after they were due is to flout basic regulatory requirements. Steadman's cavalier treatment of his reporting obligations frustrated the statutory design. We stressed the importance of these reports back in 1965 when we materially revised the form on which they are made. At that time we said:

> "[T]he data in both reports [an expanded public portion and a non-public section] will materially assist the Commission in its inspection program and will enable its inspectors to do their job more effectively and in a shorter time. In addition, the reports will serve the added purpose of laying before persons responsible for the management and operations of investment companies information which will

assist them to determine more readily whether the statutory standards and requirements are, in fact, being complied with, and thus in a measure achieve a substantial degree of self-inspection." 76/

76/ Investment Company Act Release No. 4151 (January 25, 1965), p. 2. See The Scholarship Club, Inc., 43 S.E.C. 917, 927 (1968), where we denied an exemption from another of the reporting requirements of Section 30 of the Investment Company Act because "Congress balanced the need for curing the evils resulting from the failure to give investors full information against the expense involved in reporting, and resolved the question in favor of requiring semi-annual reports." These same considerations apply here in the case of annual reports to the Commission. See also Prudential Insurance Company of America, 41 S.E.C. 335, 356 (1963), affirmed sub nom. Prudential Insurance Company of America v. S.E.C., 326 F.2d 383 (C.A. 3, 1963), certiorari denied, 377 U.S. 953.

The matter would be serious enough if we were dealing only with the respondents' failure to file their own reports. But there is much more to it than that. Many of the reports involved were due not from them but from their investment company clients. They were under fiduciary and contractual duties to those clients to file the reports on time. Hence the admitted late filings cannot be shrugged off as mere clerical slip-ups. Their egregious lateness has grave public interest implications.

VII. INTERCOMPANY TRANSACTIONS

During 1969 and 1970, Steadman Ameri-Fund, a foreign, unregistered investment company 77/ whose investment adviser was SSC, bought and sold securities directly from several registered investment companies for which

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77/ Steadman Ameri-Fund was a closed-end investment company formed under the law of the Netherlands Antilles. It grew out of an alliance between Steadman and five European banks. Those banks owned all of Ameri-Fund's stock.

SSC also served as investment adviser. 78/ Respondents assert that the administrative law judge erred in finding that those transactions violated Section 17(a) of the Investment Company Act.

Section 17(a) prohibits, absent an exemption, purchases of securities from or sales to a registered investment company by an affiliated person of such investment company, or by an affiliated person of such affiliated person. The question is whether Ameri-Fund was an affiliate of an affiliate of the registered funds.

Section 2(a)(3)(C) of the Act defines "an affiliated person" of another person to include "any person directly or indirectly

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78/ Ameri-Fund, which had no officers, was managed by an entity called Steadman International Capital Corporation ("Intercap"). Half of Intercap's shares were owned by SSC. The European banks owned the other half. Steadman was Intercap's president. More important, Intercap delegated the management of Ameri-Fund's portfolio to SSC. The governing documents gave SSC sole investment discretion.

controlling, controlled by, or under common control with, such other person." Moreover, an investment company's investment adviser is always an affiliated person of the advisee. 79/ Thus SSC, as adviser to both Ameri-Fund and the registered funds, was an affiliated person of each of them. But Ameri-Fund was not an affiliated person of the registered funds with which it dealt. However, if Ameri-Fund were directly or indirectly controlled by an affiliated person of the registered funds, viz. SSC, Ameri-Fund would have been an affiliated person of an affiliated person of the registered funds.

Respondents contend that SSC did not control Ameri-Fund. 80/ But Ameri-Fund was simply a portfolio of securities. To control that portfolio (and SSC had sole investment discretion with respect to it) was to

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79/ Section 2(a)(3)(E).

80/ Section 2(a)(9) of the Act defines "control" as "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company."

control Ameri-Fund. 81/ Hence SSC controlled Ameri-Fund. That made Ameri-Fund an affiliated person of an affiliated person of the

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81/ Respondents' contentions to the contrary rest in large measure on the patently predominant position of the European banks that owned all of Ameri-Fund's stock. That they had ultimate control is plain. When dissatisfied with Steadman, they ousted him. But that did not happen until after the close of the relevant period. During that period Steadman was running Ameri-Fund. So he had the power to exercise a controlling influence over the management or policies that Section 2(a)(9) equates with "control."

Respondents point out that when a person's controlling influence "is solely [emphasis added] the result of an official position with such company" (Section 2(a)(9)), he is not deemed to control it. This does not aid them. That exclusion applies to officers and directors because officerships and directorships are official positions. An investment adviser, on the other hand, holds no "official position" by

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registered companies. It follows that Section 17(a) prohibited the swapping of

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(81 Continued)

> virtue of his advisership. He is an independent contractor. Moreover, the term "investment adviser" is to some extent a misnomer. It is a time-honored misnomer enshrined in the Act which borrowed its vocabulary from that of the pre-1940 investment company industry. The so-called "adviser" is no mere consultant. He is the fund's manager. See page 46 of our 1966 report on the Public Policy Implications of Investment Company Growth. House Report No. 2337, 89th Cong., 2d Sess. Hence the investment adviser almost always controls the fund. Only in the very rare case where the adviser's role is simply that of advising others who may or may not elect to be guided by his advice (and there is no contention that this was Ameri-Fund's situation) can the adviser realistically be deemed not in control.

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securities between Ameri-Fund and the registered domestic companies. 82/

(81 Continued)

Hence we find no substance to the respondents' argument that no adverse finding can be made because of the sentence in Section 2(a)(9), which reads: "Any person who does not ... own more than 25 per centum of the voting securities of any company shall be presumed not to control such company." That presumption is rebuttable. And an investment advisership is normally enough in itself to rebut it. The adviser's controlling influence over his advisee does not stem from stock ownership. It stems from the fact that he manages the fund's affairs and that his is normally the only audible voice in day-to-day management.

82/ Respondents have moved that all allegations regarding transactions with Ameri-Fund be dismissed because we earlier accepted offers of settlement from that fund and from Intercap.

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We are therefore constrained to find that SSC and Steadman willfully aided and abetted

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82 Continued/

Thus, they argue, we prejudged the issues with respect to them. This contention is without merit. The order accepting the offers of settlement expressly stated that "[t]he findings herein are not binding upon any other respondent named in the proceedings." Investment Company Act Release No. 7378 (September 22, 1972). And our press release also stated that our findings were based on offers of settlement. No prejudgment occurs when prior findings against another respondent are based on that respondent's offer of settlement. See Atlantic Equities Company, 43 S.E.C. 354, 366 (1967), aff'd sub nom. Hansen v. S.E.C., 396 F.2d 694 (C.A.D.C.), cert. den., 393 U.S. 847 (1968). Moreover, the Administrative Procedure Act exempts the members of the Commission from the separation of functions requirement applicable to our staff.

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violations of that section in each of the twelve instances in which they caused the domestic companies to buy securities from or sell them to Ameri-Fund. 83/

Had Ameri-Fund been registered under the Act, these transactions would have been perfectly lawful. That is so because of our Rule 17a-7 under Section 17(a), which exempts most intra-complex swaps from the sweep of the statutory prohibition. Rule 17a-7 was adopted "to serve the interests of investors by permitting

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(82 Continued)

5 U.S.C. §5554. This permits us to consider a matter in our administrative capacity and thereafter render a decision with respect to it in our quasi-judicial capacity. See Attorney General's Manual on the Administrative Procedure Act (1947), p. 58. Finally, as stated above, our decision here is based solely on the record now before us.

83/ As noted earlier, Steadman was chairman of SSC's board of directors and owner of all its voting stock. So SSC's decisions were Steadman's decisions.

affiliated registered investment companies, which previously may have purchased or sold securities on the open market in order to avoid the application procedures of Section 17(b) and thereby incurred duplicate brokerage charges, to effect such transactions with each other and pay no charges." 84/ Since Ameri-Fund was not registered, these transactions required an exemptive order from us. We do not condone the failure to seek such order 85/ or

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84/ 33 S.E.C. Ann. Rep. 117 (1967).

85/ That failure is said to have been based on the advice of counsel. But no showing has been made that counsel were ever asked to opine on this point. They were consulted about other legal problems presented by the Ameri-Fund venture. Thus, for example, they advised Steadman that Ameri-Fund did not have to register under either the Investment Company Act or the Securities Act. That advice appears to have been correct. But it had no bearing on Section 17's reach.

orders. 86/ But realism requires us to take account of the following factors:

(1) The rationale of Rule 17a-7 applies to these transactions. Each of them could have been effected with perfect legality in the open market through a broker. Had that been done, the net effect on investors would have been the same as it was. But substantial brokerage commissions would have been expended.

(2) No showing has been made that any of the companies involved was harmed.

These violations were somewhat technical. Hence they are of little weight in assessing sanctions.

86/ We think that such applications would have been granted. And we do not believe that a succession of applications would have been needed. Steadman could have sought an order exempting the entire class of transactions. Such orders are frequent under the Investment Company Act.

VIII. THE PUBLIC INTEREST

A. Introduction

The administrative law judge described the case as "novel and complex." That is true of many areas. But those are peripheral.

The central areas are deceit and reckless disregard of applicable filing requirements. Both have long been known. 87/ Both are

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87/ Respondents make much of the fact that no previous litigated case to come before us involved collateral banking relationships of this type. (We have had other cases in that general area. But all of them were settled.) That does not seem especially significant. All that is involved here is the duty to tell the truth. That the particular context in which that duty was breached was never dealt with in an earlier case is of little, if any, moment. Suppose, for example, that another case about investment company banks accounts comes up next year. Suppose that, in that one, the investment

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simple. And both are extremely serious. We agree with the administrative law judge that "Strong sanctions are required to protect the public interest." 88/

(87 Continued)

adviser simply wrote himself a check for all the money in the investment company's bank account. Would he be heard to argue that a remedial proceeding based on his failure to make appropriate disclosures is a juridical novelty and that this absence of relevant precedent requires that sanctions be softened or withheld altogether?

88/ This seems as good a place as any to deal with the respondents' vitriolic attacks on the administrative judge. Those seem baseless to us. They say, for example, that his "opinion ... is but a duplicate of the briefs submitted by the Division of Enforcement." But the administrative judge found against the Division on a number of points. True, he happened to agree with the Division on the basic things. That, however, scarcely brands

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They are needed for two reasons. The first is that our governing statutes are drawn on

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him an unfit judicial officer. Though our views diverge from those of the administrative judge at a number of points, we find his conduct of the case unexceptionable.

Nor can we agree that the administrative judge applied an erroneous standard of proof. He guided himself by the "preponderance of the evidence" standard. Respondents say that the "clear and convincing" standard controls. We think that the administrative law judge was right. Hence we reaffirm our prior holdings that in remedial proceedings of this character a preponderance of the evidence is sufficient to establish the truth of an allegation. Norman Pollisky, 43 S.E.C. 458, 459-460 (1967); Underhill Securities Corporation, 42 S.E.C. 689, 695 (1965); White and Weld, 3 S.E.C. 466, 539-540 (1938). These are not criminal proceedings. Even if we were seeking to

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the premise that past misconduct gives rise to an inference of probable future misconduct. When the misconduct is as egregious as it is in this case, we must take effective measures to protect investors and the public interest from future harm at the wrongdoers' hands.

The second factor that leads us to agree with the administrative law judge's assessment of the quantum of remedial action that the public interest demands is the impact that the decision is likely to have on the welfare of investors as a class and on the ethical climate of the walks of life that we regulate. Leniency in a case of this character is bound to encourage irresponsibility, cavalier attitudes toward basic disclosure

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(88 Continued)

discipline a lawyer, the preponderance of the evidence standard would govern. Charlton v. F.T.C., 543 F.2d 903 (C.A.D.C., 1976). In any event, this burden of proof controversy is now pointless. Our opinion is based on the undisputed facts and on the inferences that we have drawn from them.

obligations, and disregard for inconvenient filing requirements. That cannot be done. As the Court of Appeals for the Second Circuit recently noted: "The purpose of sanctions must be to demonstrate not only to petitioner but to others that the Commission will deal harshly with egregious cases." 89/

B. Steadman's Case

So egregiously faithless a fiduciary as Steadman 90/ cannot be permitted to meddle

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89/ Lipper v. S.E.C., 547 F.2d 171 (C.A. 2, 1976).

90/ Our conclusion that Steadman has shown himself a faithless fiduciary is based not on the banking relationships themselves (see n. 25, supra), but on:

(1) Steadman's intentional and protracted concealment of those relationships from the funds' actual and prospective shareholders, from the funds' independent directors, and from this Commission; (compare Santa Fe Industries, Inc. v. Green, ____ U.S. ____, 97 S.Ct. 1292, 1299 (1977)); and

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(90 Continued)

(2) His causing his corporate instrumentalities to commit flagrant and intentional breaches of their contractual and fiduciary duties to see to it that the funds complied strictly with their reporting obligations to us--obligations that Steadman's instrumentalities had undertaken to perform for the funds and which, as Steadman well knew, the funds were wholly incapable of performing for themselves.

The boundaries of the fiduciary concept are necessarily hazy. Much often depends on the particular factual setting and on the precise questions presented. But some things are axiomatic. It seems to us that among those axioms is the proposition that federal statutes of general application are at least as binding on fiduciaries as they are on other people. It follows that when a fiduciary breaks laws enacted for the benefit of his cestuis que trust, he breaches his fiduciary duties to them. And that is exactly what Steadman did. Accordingly,

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further with other people's money. 91/ Hence we agree with the administrative

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(90 Continued)

> we think it much too clear for argument that he engaged in acts and practices "constituting a breach of fiduciary duty involving personal misconduct in respect of [a] registered investment company" within the meaning of that phrase as used in Section 36(a) of the Investment Company Act.

91/ We would reach the same conclusion if the Investment Company Act said nothing about "a breach of fiduciary duty involving personal misconduct." In fact, however, Section 36(a) of the Investment Company Act not only stigmatizes such breaches, but authorizes the courts to enjoin persons who have committed them or who are about to commit them from further association with registered investment companies. Now it is quite true that, as Carl L. Shipley, Securities Exchange Act Release No. 10870, Investment Company Act Release

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law judge that Steadman must be excluded from both the investment company business and the

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(91 Continued)

No. 8394, Investment Advisers Act Release No. 419 (June 20, 1974), 4 SEC Docket 476, 478, pointed out, Section 36 "simply authorizes the Commission to file an action in the Federal court and empowers the court to grant appropriate relief." Hence Shipley held that "Section 36 cannot serve as the sole [emphasis added] basis for administrative sanctions."

But Shipley also explained that:

> "Our conclusion that we cannot conduct an administrative disciplinary proceeding based solely upon an alleged violation of Section 36 does not mean that we have no authority to take cognizance of that section in a proceeding otherwise appropriately before us. [And this is such a

(Continued)

investment advisory profession generally. Like the one from which the respondents appealed, our order will:

(91 Continued)

> proceeding.] Section 36(a) has been held to be more than a mere grant to the federal courts of jurisdiction to apply common law principles. It is also a means of enforcing the Investment Company Act. [At this point a footnote (n. 15 reprinted at p. 480 of 4 SEC Docket) cited and quoted from Brown v. Bullock, 194 F. Supp. 207, 238 (S.D.N.Y. 1961), affirmed on other grounds, 294 F.2d 415 (C.A. 2, 1961).] Consequently, ... in an administrative proceeding where we had found willful violations of some other provisions of the Act, we could, on the issue of what sanction was appropriate, consider and

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(A) Permanently prohibit Steadman from associating himself with any registered

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(91 Continued)

> determine whether or not the respondent had committed a breach of trust involving personal misconduct within the meaning of Section 36."

For reasons developed in the foregoing extract from our Shipley opinion, we have the power, and indeed the duty, to take the status of Steadman's conduct under Section 36 of the Investment Company Act into account when we assess the sanction here. Steadman suggests that this is unfair to him because the order for proceedings gave him no notice that fiduciary duty would be an element in the case. The claim is frivolous. Section 36 has no substantive significance here. It goes only to the question of sanction. And on that question the range of pertinent considerations is almost infinite.

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investment company or any investment adviser to, depositor of, or principal underwriter

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(91 Continued)

See International Shareholders Services Corporation, Securities Exchange Act Release No. 12389A (June 8, 1976), 9 SEC Docket 821, 825-826 n. 19: "Assessing the nature of the remedial action that the public interest calls for under the concrete circumstances of a particular case is a serious and an onerous task. Many factors (some of them more easily felt than articulated) are worthy of consideration .... The range of inquiry is broad."

Even in a criminal case, which this is not, a defendant would be altogether unable to make anything out of the fact that the indictment failed to give him notice of each and every circumstance that the court might possibly take into account on sentencing.

Though these proceedings are not criminal, they are intensely serious.

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for any such company in any of the capacities specified in Section 9(b) of the Investment Company Act; 92/

(91 Continued)

And we take them very seriously indeed. But since counsel have had opportunity to argue the sanction questions and have in fact argued them at great length, we see no unfairness here.

92/ Section 9(b) reads in pertinent part:

> "The Commission may ... prohibit, conditionally or unconditionally, either permanently or for such period of time as it in its discretion shall deem appropriate in the public interest, any person from serving or acting as an employee, officer, director, member of an adisory board, investment adviser or depositor

(Continued)

(B) Bar him from association with any

(92 Continued)

> of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor or principal underwriter if such person-- ... (2) has willfully violated any provision of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of title II of this Act [the Investment Advisers Act], or of this title, or of any rule or regulation under any of such statutes."

Section 9(b)(3) confers a like power on us with respect to any person who "has willfully aided, abetted, counseled, commanded, induced or procured the violation by any other person of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of title II of this Act, or of this title, or of any rule or regulation under any of such statutes."

investment adviser; 93/ and

(C) Suspend him for one year from association with any broker or dealer.

93/ Steadman questions our power to do this. He raises a comparable question about the reach of Section 9(b) of the Investment Company Act, quoted in the preceding footnote. The two arguments rest on a single foundation. Hence we treat them together.

Steadman correctly points out that before the Investment Company Amendments Act of 1970 (84 Stat. 1413, et seq.) neither the Investment Company Act nor the Investment Advisers Act empowered us to take the action that we now propose to take with respect to him under the post-1970 versions of those statutes. The pre-1970 version of the Investment Company Act made no provision at all for administrative remedies. Our 1966 Public Policy report noted (at pp. 338-340) that this was an anomaly and urged a curative amendment along the lines of present Section 9(b).

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The administrative law judge explained that he was imposing "less severe sanctions ...

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> The Investment Advisers Act presented a somewhat similar situation. Though that statute authorized administrative proceedings ever since it was first enacted in 1940, those proceedings prior to 1970 related to firms rather than to people. We had no administrative power to bar anyone from association with an investment adviser. Nor could we suspend or limit such associations. That was a significant shortcoming. Congress rectified it. It did so by amending the Advisers Act. (The Investment Company and Investment Advisers Acts are intimately related. Indeed, the two were enacted together as Title I and Title II of the same bill. 54 Stat. 789 (1940). So the Congress addressed itself to both statutes in the Amendments Act of 1970.) The pertinent change in the Advisers Act was the addition of present Section 203(f). 84 Stat.

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against Steadman under the Exchange Act than the maximum sanctions imposed upon him

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93 Continued/

1432. That empowered us to proceed against persons under the Advisers Act just as we had been doing under the Exchange Act ever since 1964 when the Securities Amendments Act of that year revised Section 15(b) of the 1934 statute.

The amendments that we have just described became effective on December 14, 1970. Steadman reasons that this means that no sanctions can be imposed under either Section 9(b) of the Investment Company Act or Section 203(f) of the Investment Advisers Act for anything that happened before December 14, 1970. For the moment we assume, arguendo, that he is right about that. The result is unaffected. The order that initiated these proceedings issued on June 23, 1971, more than six months after the effective date of the 1970 amendments. And much of the alleged

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under the I.C.A. and the Advisers Acts because the violations under the last two

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misconduct occurred after the amendments had become law. Thus, for example, the failures to file reports when due relate to the years 1971 and 1972. With respect to those, Steadman gains nothing from historical references to the pre-December 14, 1970 deficiencies in our catalogue of remedies. Nor do those references aid him on the fraud issues, the very heart of the case. His concealments were continuing wrongs. They did not stop on December 14, 1970. They went on far beyond that date.

Moreover, Steadman's premise is erroneous. He relies on the constitutional ban on ex post facto laws. U.S. CONST. art. I, § 9, cl. 3: "No ... ex post facto law shall be passed." But this clause applies only to retroactive penal legislation. Calder v. Bull, 3 Dall.

(Continued)

Acts are deemed more significant in terms of the need for long-range protection of the public interest." But the heart of this case is deception. And that deception was calculated and protracted. Such a propensity to deceive is as unsuitable in a broker or dealer as it is in an investment

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93 Continued/

386 (1798). Hence, it interposes no bar to the retrospective application of tests of fitness in licensing statutes. Hawker v. New York, 170 U.S. 189 (1898). Moreover, Sections 9(b) and 203(f) effected no substantive changes. They had no effect on the substantive legality of the conduct here involved. The concealments were made illegal back in 1933. And the filing duties involved date back to the early years of the Exchange and Investment Company Acts. The changes that went into effect on December 14, 1970, went solely to matters of remedy and had no bearing on legal rights or legal duties.

adviser or in an investment company manager. 94/

When shall the sanctions take effect? Where we have found the misconduct serious enough to warrant a bar, the bar order normally becomes effective on issuance. 95/ That seems inappropriate here.

Steadman is the active operating head of the management organization. To oust him

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94/ Cf. Thomas E. Jackson, Securities Exchange Act Release No. 11476 (June 16, 1975), 7 SEC Docket 193, 194: "Although Jackson's wrongdoing in this instance did not involve securities, the NASD could justifiably conclude that on another occasion it might."

95/ But when barred or revoked respondents appeal or indicate that they intend to appeal to the Court of Appeals, we give stays of sufficient duration to enable them to seek further stays from the courts. See Nassar & Company, Inc., Securities Exchange Act Release No. 13081 (December 17, 1976), 11 SEC Docket 1221, 1222; Arleen W. Hughes, 27 S.E.C. 952, 956 (1948).

at once might leave the funds in difficult straits, albeit temporarily. We think it better to permit him to remain on board for 90 days. That should give the funds' directors adequate opportunity to make appropriate arrangements for their beneficiaries' post-Steadman future.

Another factor that leads us to deem a 90-day stay appropriate is our wish to be fair to Steadman himself. His SSC stock may well be of substantial economic value. We see no need to divest him of that value. The 90-day transitional period gives him abundant time to find a buyer.

C. The Corporate Respondents

Stating that he saw no reason to visit Steadman's sins and those of SSC on their co-respondents, the administrative law judge tried to assess the precise culpability of each corporate respondent. He first found SSC guilty of grave wrongdoing. He then predicated his conclusions with respect to the four SSC subsidiaries before him on "the number, nature and gravity of violations committed by each particular respondent." Normally, we should commend that course. Every effort should be made in proceedings of this character to steer clear of even a hint of guilt by association.

But such efforts must be tempered by realism. The corporate respondents in this case are all Steadman's instrumentalities. That one of them happened to transgress more than another was mere accident. It suited Steadman to do things that way.

The administrative law judge thought that SSC should be put out of business. Were we to agree with him about that, we should conclude that SSC's wholly owned subsidiaries deserve the same fate. But we see no pressing need for any sanctions at all on either SSC or its children.

It is the real parent, not SSC but Steadman himself, at whom the remedy must be aimed. His corporate children can safely be left alive for adoption by others, just as Steadman himself in days gone by acquired advisory and broker-dealer entities from people unaffiliated with him. Were this the usual one-man corporation case, the result would be different. There no one has any real interest in the corporation other than its sole controlling person. Hence sanctions on him are normally coupled with correlative sanctions on his corporate alter ego.

Two factors appear to make this approach inappropriate here. One is SSC's nature and function. The SSC organization manages what is still a fairly substantial investment company complex. Were that organization to be liberated from Steadman's influence and were control over it to pass to clean hands, the continued existence of the SSC organization would be perfectly compatible with the public interest. 96/

96/ Compare Arthur Lipper Corporation, Securities Exchange Act Release No. 11773 (October 24, 1975), 8 SEC Docket 273, 281 (1975), modified on an appeal by other respondents sub nom. Lipper v. S.E.C., 547 F.2d 171 (C.A. 2, 1976): "IPC's case differs materially from IOS's. IPC was a mere instrumentality. It was never an independent actor. Moreover, its present owners are wholly unaffiliated with IOS. It follows that a sanction against IPC could not possibly tend to achieve any remedial purpose. We therefore find it in the public interest to discontinue the proceedings, so far as they relate to IPC."

Secondly, we cannot ignore SSC's non-voting shareholders. 97/ To revoke the corporate respondents' registrations with us would be to strip them of the going concern value (actual and potential) of their interest. There is no compelling public interest reason to do that.

Finally, the imposition of sanctions on the corporate respondents at this time would be inconsistent with our decision to give Steadman a reasonable time within which to dispose of his SSC stock, if he can. Were we to put SSC out of business now, Steadman would be left with nothing to sell.

If Steadman had already sold out to a responsible and competent successor, we should dismiss here and now as against all of the corporate respondents. 98/ But

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97/ Some of them may be public investors.

98/ We should also grant the applications of three of them (Steadman Investment Services Corporation, Aberdeen Management Corporation, and Republic Securities Corporation) for the withdrawal of their registrations as brokers

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there is no assurance that such a successor will appear. So dismissal at this time would be patently premature.

Having given Steadman 90 days to find a buyer, we now give SSC that same 90 days to liberate itself from his influence. If an adequate showing is made within those 90 days that all links between SSC and Steadman have in fact been severed and that SSC is in new and responsible hands, we shall dismiss as to it and its subsidiaries. SSC's failure to make such a showing will necessitate a reassessment of the situation at the end of the 90-day period. Hence the order we enter this day will reserve jurisdiction over the corporate respondents.

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98 Continued/

and dealers. In view of the position taken in the text and in the Lipper case cited supra, we should be constrained to find that the tests set forth in our Rule 15b6-1(b) under the Exchange Act had been satisfied.

IX. CONCLUSION 99/

Our order will:

(A) Bar Steadman from association with any investment adviser;

(B) Prohibit him permanently 100/ from serving or acting as an employee, officer,

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99/ Some of the many contentions made have not been treated explicitly. This does not mean that we have ignored them. All points presented have been carefully considered.

100/ The word "permanently" is taken from Section 9(b) of the Investment Company Act. However, we always retain control over our own orders. Inherent in the power to issue orders of this type is the power to modify them. Hence "permanently" in this context really means "indefinitely." The bar from association with any investment adviser is also of indefinite duration. See Applications for Relief from Disqualification, Securities Exchange Act Release

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director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter;

(C) Suspend him for one year from association with any broker or dealer;

(D) Stay the effective date of the aforementioned sanctions for 90 days from the date hereof, thus:

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100 Continued/

No. 11267, Investment Company Act Release No. 8689, Investment Advisers Act Release No. 438 (February 26, 1975), 6 SEC Docket 346. Judicial notice has been taken of our discretionary power to lift or modify disqualifications. The authorities are collected in John R. Brick, Securities Exchange Act Release No. 11763, Investment Advisers Act Release No. 483 (October 24, 1975), 8 SEC Docket 240, 247-248 n. 38, where we stated that "so-called lifetime bars are actually bars of indefinite duration."

(i) facilitating an orderly transition to new management wholly divorced from Steadman's influence; and

(ii) giving Steadman himself an adequate opportunity to dispose of his SSC stock;

(E) Require SSC to file a report with us about what, if anything, has been done to sever Steadman's links to it; 101/

(F) Reserve jurisdiction to enter such other, further, and different orders with respect to the corporate respondents as we in our discretion may hereafter deem appropriate in the public interest and for the protection of investors in light of the contents of the aforementioned report--or

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101/ This report shall be filed within 90 days from the date hereof and shall be accompanied by proof of service on our Division of Enforcement and on our Washington Regional Office.

if no such report should be filed, in light of the failure to file it. 102/

By the Commission (Chairman WILLIAMS and Commissioners LOOMIS and EVANS); Commissioner POLLACK not participating.

George A. Fitzsimmons
Secretary

102/ Respondents' objections to the initial decision are overruled or sustained to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 13695 / June 29, 1977

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 593 / June 29, 1977

INVESTMENT COMPANY ACT OF 1940
Rel. No. 9830 / June 29, 1977

Admin. Proc. File No. 3-3101

In the Matter of

STEADMAN SECURITY CORPORATION
1730 K Street, N.W.
Washington, D. C.
(801-8141)

CHARLES W. STEADMAN

REPUBLIC SECURITIES CORPORATION
(8-13223)

STEADMAN INVESTMENT SERVICES CORPORATION
(8-14704 and 801-5679)

THE STEADMAN CORPORATION OF AMERICA
(8-13955)

ABERDEEN MANAGEMENT CORPORATION
(8-1867)

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is

ORDERED that Charles W. Steadman be, and he hereby is,

(1) Barred from association with any investment adviser;

(2) Permanently prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and

(3) Suspended for one year from association with any broker or dealer; and it is further

ORDERED that the above sanctions shall become effective at the opening of business on October 3, 1977; and it is further

ORDERED that Steadman Security Corporation be, and it hereby is, directed to file twelve copies of a report with the Secretary of the Commission (to be accompanied by proof of service on the Commission's Division of Enforcement and on its Washington Regional Office) setting forth in detail the steps, if any, that have been taken to sever Steadman's links to

it; and it is further ORDERED that Steadman Security Corporation file the aforementioned report on or before October 3, 1977; and it is further

ORDERED that jurisdiction be, and it hereby is, reserved with respect to all of the corporate respondents herein to enter such other, further, and different orders as the Commission may in its discretion deem appropriate in the public interest and for the protection of investors in light of the contents of the aforementioned report--or if no such report should be filed, in light of the failure to file it.

By the Commission.

George A. Fitzsimmons
Secretary

Supreme Court, U. S.
FILED
APR 4 1980
MICHAEL RODAK, JR., CLERK

No. 79-1266

In the Supreme Court of the United States

OCTOBER TERM, 1979

CHARLES W. STEADMAN, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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In the Supreme Court of the United States

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SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-34) is reported at 603 F. 2d 1126. The opinion of the Securities and Exchange Commission (Supp. App. 1-122) is reported at 12 S.E.C. Docket 1041.

JURISDICTION

The judgment of the court of appeals was entered on October 4, 1979, and a petition for rehearing was denied on November 27, 1979. The petition for a writ of certiorari was filed on February 15, 1980. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, in an administrative proceeding before the Securities and Exchange Commission, violations of

antifraud provisions of the federal securities laws must be proved by clear and convincing evidence, rather than by a preponderance of the evidence.

STATEMENT

In June 1971, the Securities and Exchange Commission instituted an administrative proceeding against petitioner Steadman and certain of his wholly owned companies, including Steadman Securities Corporation ("SSC"), an investment adviser registered with the Commission, and Republic Securities Corporation ("RSC"), a broker-dealer registered with the Commission. The administrative order initiating the proceeding alleged violations of various provisions of the federal securities laws resulting from petitioner's management (through his wholly owned companies) of several mutual funds registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.*

After an evidentiary hearing, the Commission found that petitioner had violated various antifraud[1] and reporting[2] provisions of the federal securities laws by, *inter alia*, intentionally concealing his practice of obtaining loans for himself and certain of his wholly owned companies from banks in which he caused the mutual funds that he managed ("the Funds") to maintain large cash deposits in non-interest-bearing checking

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[1]Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5; Section 206(1) and (2) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-6(1) and (2).

[2]Section 17(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78q(a), and Rule 17a-5 thereunder, 17 C.F.R. 240.17a-5; Sections 20(a), 30(a) and 34(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-20(a), 80a-29(a) and 80a-33(b).

accounts (Supp. App. 32-37, 79-81).[3] In making its findings, the Commission utilized the traditional standard of proof applicable in administrative proceedings involving alleged violations of the federal securities laws — the preponderance of the evidence standard (Supp. App. 97-99 n.88). In light of the serious violations that it found, the Commission determined that petitioner should be barred permanently from association with investment advisers or registered investment companies and also should be suspended for one year from association with brokers or dealers in securities (Supp. App. 95-113).

Petitioner sought review of the Commission's decision in the United States Court of Appeals for the Fifth Circuit, contending, *inter alia*, that the Commission should have utilized the clear and convincing evidence standard rather than the preponderance of the evidence standard in evaluating the record. The court of appeals rejected that contention, holding that proof by a

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[3]The Commission also found that (1) petitioner, SSC, and its subsidiaries failed to file timely annual reports for three of the Funds and for petitioner's four broker-dealer firms, in violation of Section 30(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-29(a), and Section 17(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78q(a) (Supp. App. 78-85); (2) RSC, aided and abetted by SSC and petitioner, accepted and retained solicitation fees for tender of securities held by the Funds when SSC was already being compensated for the decision to tender the securities in its capacity as investment adviser to the Funds, in violation of Section 17(e) of the Investment Company Act of 1940, 15 U.S.C. 80a-17(e) (Supp. App. 73-77); (3) SSC failed promptly to remit excess advisory fees received from the Funds, in violation of Section 15(a)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-15(a)(1) (Supp. App. 67-71); (4) petitioner and SSC failed to disclose its retention of these excess fees, in violation of various antifraud and reporting provisions (Supp. App. 72-73); and (5) petitioner and SSC caused certain of the Funds to buy securities from and sell securities to other Funds, thereby aiding and abetting violations of Section 17(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-17(a) (Supp. App. 85-94).

preponderance of the evidence was sufficient in this context (Pet. App. 26). In so holding, the court of appeals expressly declined to follow the decision of the United States Court of Appeals for the District of Columbia Circuit in *Collins Securities Corp.* v. *SEC*, 562 F. 2d 820, 824 (1977), which required the Commission to employ a clear and convincing evidence standard in administrative proceedings brought against broker-dealers under Section 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*(b), which involve allegations of fraud and substantial sanctions (Pet. App. 23-25).

The court below followed the approach of this Court in *Addington* v. *Texas*, 441 U.S. 418, 428-433 (1979), in balancing petitioner's interest and the public interest (Pet. App. 24). The court was of the view that the risk that petitioner might be excluded from the investment advisory business due to an erroneous finding of fact did not outweigh the potential injury to the public from an erroneous finding. Accordingly, the court of appeals held that it was appropriate for both parties here to bear the risk of error equally by use of a preponderance of the evidence standard of proof (Pet. App. 26).[4]

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[4]The court of appeals remanded the case to the Commission so that the Commission could further explain its rationale for the sanction imposed in this case (Pet. App. 27). Despite this remand, we believe that the standard of proof issue is ripe for review by this Court at this time. The Commission's further explanation of its choice of remedy would not aid this Court in resolving the legal issue of the applicable standard of proof. Moreover, clarification of the standard of proof question at this juncture should permit the Commission to dispose finally of all of the disputed questions in this proceeding upon remand and will avoid the need for multiple remands to the Commission in the event that this Court were to disagree with the Fifth Circuit on the applicable standard of proof.

DISCUSSION

The court of appeals correctly determined that proof by clear and convincing evidence is not required in Commission administrative proceedings involving alleged violations of the antifraud provisions of the federal securities laws. Nevertheless, in view of the importance of the burden of proof standard to the administration of the federal securities laws and the conflict among the circuits as to the appropriate standard, the Commission believes that the petition for a writ of certiorari should be granted.

1. The issue raised by petitioner is important. The Commission is charged with enforcing the federal securities laws for the protection of investors, and one of the principal means by which the Commission carries out this mandate is through the commencement of administrative proceedings against securities industry professionals and others to determine whether they have violated the federal securities laws.[5] In such proceedings, the Commission endeavors to protect the general public and investors from violations of the law, and the sanctions that it imposes are remedial in nature.[6] The court below properly recognized (Pet. App. 26) that, if the Commission were required to evaluate the evidence under a "clear and convincing" standard of proof, its ability to enforce the laws governing the securities

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[5]See, *e.g.*, Section 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*(b); Section 9(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-9(b); Section 203(e) and (f) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-3(e) and (f).

[6]*Berko* v. *SEC*, 316 F. 2d 137, 143 (2d Cir. 1963); *Blaise D'Antoni & Associates, Inc.* v. *SEC*, 289 F. 2d 276, 277 (5th Cir.), rehearing denied per curiam, 290 F. 2d 688, cert. denied, 368 U.S. 899 (1961); *Associated Securities Corp.* v. *SEC*, 283 F. 2d 773, 775 (10th Cir. 1960); *Pierce* v. *SEC*, 239 F. 2d 160, 163 (9th Cir. 1956); *Wright* v. *SEC*, 112 F. 2d 89, 94 (2d Cir. 1940).

industry would be significantly eroded and investors would be deprived of protections intended by Congress.

The standard of proof question raised in this case is a continually recurring question.[7] The Commission is authorized to bring administrative proceedings charging violations of the antifraud provisions of the federal securities laws under several of the statutes that it administers. Numerous Commission administrative proceedings are brought each year, a large number of which allege violations of antifraud provisions.[8]

2. The decision of the court of appeals in this case directly conflicts with two decisions of the District of Columbia Circuit concerning the applicable standard of proof in an administrative proceeding involving alleged violations of antifraud provisions of the federal securities laws. See *Collins Securities Corp.* v. *SEC*, 562 F. 2d 820 (1977), and *Whitney* v. *SEC*, 604 F. 2d 676 (1979). In

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[7]See, *e.g.*, *In re Sartain*, Securities Exchange Act Release No. 16561, 19 S.E.C. Docket 562 (Feb. 8, 1980); *In re Podesta*, Securities and Exchange Act Release No. 16209, 18 S.E.C. Docket 404 (Sept. 18, 1979), petition for review pending, No. 79-2335 (D.C. Cir.); *In re Nickolaou*, Securities Exchange Act Release No. 16210, 18 S.E.C. Docket 409 (Sept. 18, 1979), petition for review pending, No. 79-2314 (7th Cir.); *In re Decker*, Investment Advisers Act Release No. 641, 15 S.E.C. Docket 1342 (Oct. 16, 1978), petition for review pending, No. 78-2008 (10th Cir.); *In re Schultz*, Securities Exchange Act Release No. 15100, 15 S.E.C. Docket 860 (Aug. 28, 1978), aff'd, [Current] Fed. Sec. L. Rep. (CCH) para. 97,234 (7th Cir. 1980); *In re Lechman*, Securities Exchange Act Release No. 15101, 15 S.E.C. Docket 864 (Aug. 28, 1978), aff'd without opinion, No. 78-1869 (D.C. Cir. Dec. 12, 1979); *In re Investors Research Corp.*, Investment Company Act Release No. 10223, 14 S.E.C. Docket 1020 (May 1, 1978), petition for review pending, Nos. 78-1589 and 11597 (D.C. Cir).

[8]In the past decade (1970-1979), the Commission has instituted a total of 864 administrative proceedings in which the order commencing the proceeding alleged violations of one or more of the antifraud provisions involved in this case.

Whitney, the District of Columbia Circuit reaffirmed and extended the rule of *Collins* (see page 4, *supra*), holding that "any sanction imposed under section 15(b) [of the Securities Exchange Act of 1934] which depends on a finding of fraud must be sustained by clear and convincing evidence." 604 F. 2d at 681. In a footnote to the quoted passage, the court explained that it "intend[s] the word 'fraud' not merely in its common-law sense, but comprehending all violations of § 10(b) and rule 10b-5." *Id.* at 681 n.19.[9] The holdings of the District of Columbia Circuit cannot be reconciled with the decision of the court of appeals in the present case.[10]

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[9]The District of Columbia Circuit has recently extended the *Collins-Whitney* "clear and convincing" evidence standard to encompass broadcast license revocation proceedings conducted by the Federal Communications Commission. The court held that the revocation of a three-year FCC broadcast license for misrepresentations made by the licensee to the FCC is a sufficiently serious sanction to require application of the clear and convincing evidence standard: *Sea Island Broadcasting Corp.* v. *FCC*, No. 76-1735 (D.C. Cir. Jan. 14, 1980), slip op. 6-9.

[10]The *Collins-Whitney* rule is also contrary to decisions rendered prior to the instant case. It conflicts with decisions of the Second Circuit and in principle with decisions of the Fifth and Seventh Circuits. See *Wright* v. *SEC*, 112 F. 2d 89 (2d Cir. 1940); *In re De Mammos*, 43 S.E.C. 333 (1967), aff'd without opinion, No. 31469 (2d Cir. Oct. 13, 1967); cf. *Kent* v. *Hardin*, 425 F. 2d 1346, 1349 (5th Cir. 1970) (preponderance standard applicable to suspension of commodities broker); *G.H. Miller & Co.* v. *United States*, 260 F. 2d 286 (7th Cir.), on rehearing en banc, 260 F. 2d 294 (1958), cert. denied, 359 U.S. 907 (1959) (preponderance standard applicable to revocation of registration as futures commission merchant and floor broker).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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APRIL 1980

DOJ-1980-04

Supreme Court, U.S.
FILED
JUL 15 1980
MICHAEL RODAK, JR., CLERK

No. 79-1266

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

CHARLES W. STEADMAN,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF FOR PETITIONER

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QUESTION PRESENTED

Whether, in SEC disciplinary proceedings involving alleged violations of the anti-fraud provisions of the securities laws, the Commission's findings of violation must be supported by clear and convincing proof, rather than by a mere preponderance of the evidence.

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IN THE

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OCTOBER TERM, 1980

No. 79-1266

CHARLES W. STEADMAN,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

---

BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit, reported at 603 F.2d 1126, is reproduced at pages 1-34 of the appendix to the petition for certiorari. The opinion of the Securities and Exchange Commission, reported at 12 SEC Docket 1041, is reproduced in the supplemental appendix to the petition for certiorari.

JURISDICTION

The judgment of the court of appeals was entered October 4, 1979. Pet. App. 35. Respondent's petition for rehearing,

filed October 17, 1979, was denied by the court on November 27, 1979. Pet. App. 36. A petition for certiorari, filed within 90 days of the denial of the petition for rehearing, was granted by this Court on April 28, 1980. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTES INVOLVED

Section 9(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-9(b), and Section 203(e) and (f) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(e) and (f), are reproduced in an appendix to this brief.

STATEMENT

Petitioner is president, chairman of the board and owner of all the voting stock of Steadman Security Corporation ("SSC"), an investment adviser registered with the Securities and Exchange Commission. SSC advises and manages several mutual funds known as the Steadman Funds.

In 1971, the SEC commenced disciplinary proceedings against Steadman and SSC, pursuant to Section 9(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-9(b), and Section 203(f) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(f). At the hearing before an Administrative Law Judge, evidence was presented that Steadman and SSC had obtained commercial loans from several banks of national reputation that were custodians for some of the Steadman Funds. The Commission staff maintained that these loans had not been fully revealed to the Funds' directors or mentioned in the prospectuses. Pet. App. 3-5.[1] Petitioner demonstrated by uncontradicted evidence that the mutual funds had not been harmed by these loans, and had, in fact, benefited substantially

[1] The SSC loans had been fully revealed to and approved by the SSC Board of Directors, which included directors of each of the Funds. *See, e.g.*, Exhibits 5A, 6 and 7.

from the placement of the custodial accounts because of the unusually low custodial fees charged by these banks. The evidence also confirmed that Steadman and SSC were accorded no special consideration by the banks; the loans, secured by collateral, bore normal, competitive interest rates and were awarded solely on the basis of the borrower's ability to repay.[2] There were no allegations of commingling or misappropriation of Fund assets.

While generally finding against petitioner, the Commission specifically refused to find that the banks had granted the loans as a quid pro quo for the mutual fund accounts, or that Steadman or SSC had compromised the Funds' interests in managing the accounts. Pet. App. 6. The Commission held, however, that the existence of the loan "relationships" was material information that Steadman and SSC had a duty to reveal to the Funds' investors, and that failure to do so constituted a violation of the securities laws. The Commission's finding was based on the theory that Steadman's and SSC's loans had created the *potential* for maintaining excessive amounts of the Funds' resources in non-interest bearing checking accounts. However, the Commission's Division of Enforcement never alleged that the checking account balances were excessive, and the Commission did not make such a finding. Pet. Supp. App. 27-28 & n.8. *See also* Pet. App. 6. The Commission found that Steadman's violations had been willful. Pet. Supp. App. 34-35. In making its findings, the Commission applied the preponderance of the evidence standard of proof. *Id.* at 14, 96-97 n.88.

The Commission recognized that this was a case of first impression, noting that "no previous litigated case to come before us involved collateral banking relationships of this

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[2] The custodians of the accounts had been determined by the unanimous decisions of non-interested directors of each of the Funds. These directors were persons of reputation and distinction. See Br. for Petr., filed in Fifth Circuit, April 19, 1978, at 30 n.***.

type." *Id.* at 95 n.87.[3] Nevertheless, the SEC imposed upon Steadman the most severe sanctions at its disposal. Pet. App. 28-34.[4] These sanctions would permanently bar Steadman from associating with any investment adviser or becoming affiliated with any registered investment company, and would suspend him for one year from associating with any broker-dealer. In addition, the SEC's order would compel a distress sale of Steadman's principal asset, his stock in SSC, at a substantial loss. These extraordinary sanctions would thus cause petitioner serious financial damage and end his career as an investment adviser.

Although petitioner argued below that the SEC was required to prove the alleged violations by clear and convincing evidence, the United States Court of Appeals for the Fifth Circuit held that the violations required proof only by a preponderance of the evidence. The Fifth Circuit determined that respondents in SEC proceedings are adequately protected by the courts' power "to set aside Commission orders [of sanctions] that are arbitrary and capricious." Pet. App. 27. By relying on appellate review of SEC sanctions to protect the individual, rather than on the standard of proof in the fact-finding process, the court below rejected *Collins Securities Corp.* v. *SEC*, 562 F.2d 820 (D.C. Cir. 1977), and *Whitney* v. *SEC*, 604 F.2d 676 (D.C. Cir. 1979), each of which held that the clear and convincing standard of proof must be applied in

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[3] The Commission also found by a preponderance of the evidence that petitioner had participated as an aider and abettor in the following minor technical violations:

(a) SSC's collection of advisory fees in excess of those specified in the management contract;

(b) SSC's subsidiary's collection of tender solicitation fees to which it was not entitled; and

(c) SSC's failure to comply with certain reporting provisions.

Pet. App. 2 n.1.

[4] No sanctions were ordered against SSC or its subsidiaries; they are not parties to this action.

SEC disciplinary proceedings involving allegations of fraud and the possibility of serious sanctions.[5] The Fifth Circuit remanded, directing the Commission to "articulate a sufficient justification" for its order, which imposed the most severe sanctions at its disposal — total and permanent exclusion of petitioner from the investment advisory industry. Pet. App. 30.

The SEC's petition for rehearing was denied by the court below on November 27, 1979. Pet. App. 36. This Court granted certiorari on April 28, 1980.[6]

SUMMARY OF ARGUMENT

The Securities and Exchange Commission entered an order that would permanently bar petitioner from practicing his profession and force immediate divestiture of his investment advisory business, resulting in enormous financial loss. The question presented is whether the agency can inflict such grievous harm based upon facts satisfying only the preponderance of the evidence standard of proof, a standard characterized as the "rock bottom at the factfinding level of civil litigation." *Charlton* v. *FTC*, 543 F.2d 903, 907 (D.C. Cir. 1976).[7]

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[5] The SEC's petition for rehearing in *Collins* was denied by the court. Instead, in response to the SEC's petition, the D.C. Circuit issued a per curiam order amending and strengthening its opinion. *See* Order of Sept. 25, 1977, Collins Securities Corp. v. SEC, No. 75-2200 (D.C. Cir.).

[6] On June 2, 1980, the Court entered an order granting petitioner's motion to dispense with printing of an appendix.

[7] The preponderance of the evidence standard does not require the trier of facts to feel assured of the correctness of his findings, but only to weigh the probabilities. Thus, to make a finding under that standard, the trier of facts only "must believe that it is more probable that the facts are true or exist than it is that they are false or do not exist." McBaine, Burden of Proof: Degrees of Belief, 32 Calif. L. Rev. 242, 261 (1944) (hereinafter cited as McBaine).

The right to practice one's profession has been recognized as a fundamental aspect of personal liberty that may not be abridged without due process of law. Under principles established by this Court, a government agency may not deprive an individual of that right without ascertaining the facts to a greater certainty, such as that assured by the clear and convincing standard of proof.[8]

In this case an additional factor supports a more demanding standard of proof: the sanctions imposed upon petitioner were based upon a finding that he had committed securities fraud. Courts, including this Court, traditionally have recognized that fraud must be proved by clear and convincing evidence. A higher standard is required because, as demonstrated by the proceedings below, such findings are frequently based upon conjecture or inference and leave a lasting stigma on the individual by tarnishing his reputation. *Addington* v. *Texas,* 441 U.S. 418, 424 (1979).

No policy justifies the relaxed standard of proof embraced by the Commission. In a series of cases since the D.C. Circuit's decision in *Collins Securities Corp.* v. *SEC,* 562 F.2d 820 (D.C. Cir. 1977), the Commission has applied the more demanding clear and convincing standard without any apparent harm to its enforcement processes. On the other hand, SEC disciplinary sanctions result in grievous loss and stigma for the individual upon whom they are imposed. By selecting disciplinary

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[8] The clear and convincing proof standard is significantly more demanding than the preponderance standard. Under the clear and convincing standard, the trier of facts

> must believe that it is highly probable that the facts are true or exist; while it is not necessary to believe to the point of almost certainty, or beyond a reasonable doubt that they are true or exist, or that they certainly are true or exist; yet it is not sufficient to believe that it is merely more probable that they are true or exist than it is that they are false or do not exist.

McBaine, 32 Calif. L. Rev. at 262-63.

sanctions from its large arsenal of enforcement weapons, rather than seeking traditional remedial measures such as injunctive relief, the SEC demonstrates a desire to punish the alleged wrongdoer, not merely to protect the public. Procedural safeguards in administrative punishment cannot be sacrificed based on a mere ritual recitation of the public good.

This Court and other federal courts have consistently applied heavier standards of proof where the proceedings in question involve the possibility of severe harm to the individual and/or findings based on inference or conjecture. Moreover, imposition of the clear and convincing standard of proof in this case accords with congressional intent. The more demanding standard also accords with the great weight of authority holding that disciplinary sanctions against attorneys and other professionals require proof by clear and convincing evidence.

ARGUMENT

I.

THE CLEAR AND CONVINCING STANDARD OF PROOF MUST BE IMPOSED BECAUSE SEC DISCIPLINARY PROCEEDINGS INVOLVE THE RISK OF GRIEVOUS HARM TO THE INDIVIDUAL

As this Court has noted, "the possibility of mistaken factfinding [is] inherent in all litigation." *Speiser* v. *Randall,* 357 U.S. 513, 526 (1958). In the light of this unavoidable uncertainty, the standard of proof "serves to allocate the risk of error between the litigants and to indicate the relative importance attached to the ultimate decision." *Addington* v. *Texas,* 441 U.S. at 423. Rejecting the preponderance of the evidence standard of proof for civil commitment proceedings, *Addington* held that "[t]he individual should not be asked to share equally with society the risk of error when the possible injury to

the individual is significantly greater than any possible harm to the state." *Id.* at 427. These observations are fully applicable here. The SEC itself acknowledged the staggering consequences of an erroneous decision, characterizing the sanctions imposed on petitioner as "drastic."[9] On the other hand, the SEC's interest in imposing disciplinary sanctions is significantly smaller because it has at its disposal a number of alternative methods of protecting investors. *See* pp. 10-11, *infra.* In these circumstances, the more demanding standard of proof is clearly warranted.

Since its earliest decisions, this Court has consistently held that the right to pursue one's chosen occupation is a fundamental personal freedom guaranteed by the Constitution that cannot be denied by the Government without due process. *See, e.g., Yick Wo* v. *Hopkins,* 118 U.S. 356, 374 (1886); *Truax* v. *Raich,* 239 U.S. 33, 44 (1915); *Hampton* v. *Mow Sun Wong,* 426 U.S. 88, 102 n.23 (1976). Moreover, the Court has long recognized that "exclusion from any of the professions or any of the ordinary avocations of life for past conduct can be regarded in no other light than as punishment for such conduct." *Ex parte Garland,* 71 U.S. (4 Wall.) 333, 377 (1866). *Accord, In re Ruffalo,* 390 U.S. 544, 550 (1968). Thus, the sanction imposed upon petitioner by the SEC — permanent exclusion from his profession — is nothing less than drastic punishment. In addition, the SEC's order will result in staggering financial losses for petitioner, as it requires a forced sale of his investment advisory business.

The court below held that clear and convincing proof was not required to justify these severe sanctions, noting that such a standard might impair the Commission's ability to police the securities industry. Pet. App. 26. Yet there is compelling evidence that the heavier standard of proof in disciplinary proceedings does not significantly diminish the Commission's power to deal with securities fraud and other misconduct. Since the D.C. Circuit's decision in *Collins Securities Corp.* v. *SEC,*

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[9] SEC Stay Order of July 14, 1977.

562 F.2d 820 (D.C. Cir. 1977), respondents in twenty disciplinary proceedings before the SEC have asserted that clear and convincing proof is required before the SEC may find violations of the securities laws. In *every one* of these cases, the Commission applied the clear and convincing standard, and found the violation supported by such proof.[10] With regard to

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[10] In re Sartain, Securities Exchange Act Release No. 13,815 (Feb. 8, 1980); In re Blumenfeld, Securities Exchange Act Release No. 16,437, Fed. Sec. L. Rep. (CCH) ¶ 82,396 (Dec. 19, 1979); In re Mansfield, Securities Exchange Act Release No. 16,330 (Nov. 8, 1979); In re D.M.R. Securities, Inc., Securities Exchange Act Release No. 16,322 (Nov. 6, 1979); In re Hodgin, Securities Exchange Act Release No. 16,225, Fed. Sec. L. Rep. (CCH) ¶ 82,334 (Sept. 27, 1979); In re Podesta, Securities Exchange Act Release No. 16,209 (Sept. 18, 1979); In re Nickolaou, Securities Exchange Act Release No. 16,210 (Sept. 18, 1979); In re Seation, Securities Exchange Act Release No. 16,207 (Sept. 17, 1979); In re J.A.B. Securities Co., Securities Exchange Act Release No. 15,948 (June 25, 1979); In re West, Securities Exchange Act Release No. 15,454 (Jan. 2, 1979); In re Nassar & Co., Securities Exchange Act Release No. 15,347, Fed. Sec. L. Rep. (CCH) ¶ 81,904 (Nov. 22, 1978); In re Hinkle Northwest, Inc., Securities Exchange Act Release No. 15,338, 16 SEC Docket 173 (Nov. 16, 1978); In re Schultz, Securities Exchange Act Release No. 15,100 (Aug. 28, 1978); In re Lechman, Securities Exchange Act Release No. 15,101 (Aug. 28, 1978); In re Ernst & Ernst, Accounting Series Release No. 248 (May 31, 1978); In re Investors Research Corp., Investment Advisers Act Release No. 627, Investment Company Act Release No. 10,223, Securities Exchange Act Release No. 14,721, Fed. Sec. L. Rep. (CCH) ¶ 81,586 (May 1, 1978), *aff'd*, No. 78-1589 (D.C. Cir. April 29, 1980); In re Chatham, Securities Exchange Act Release No. 14,594 (March 23, 1978), *aff'd*, 604 F.2d 1368 (D.C. Cir. 1978); In re Douglass & Co., Securities Exchange Act Release No. 14,596 (March 23, 1978); In re International Research & Management Corp., Investment Advisers Act Release No. 617, Investment Company Act Release No. 10,151, Fed. Sec. L. Rep. (CCH) ¶ 81,547 (March 6, 1978), *aff'd*, 588 F.2d 821 (3d Cir. 1978); In re Whitney, Securities Exchange Act Release No. 14,468, (Feb. 14, 1978), *vacated and remanded*, 604 F.2d 676 (D.C. Cir. 1979) (evidence "contradictory and ambiguous"; findings "wholly unsupportable"); and In re Shaw, Hooker & Co., Securities Exchange Act Release No. 14,289 (Dec. 19, 1977).

the clear and convincing standard, there is thus no foundation for the Fifth Circuit's assertion that "[i]f the burden of proof imposed on the Commission is too high, its ability to police the industry is impaired." Pet. App. 26. At the same time, it is established that "standards of proof are important for their symbolic meaning as well as for their practical effect." *Addington* v. *Texas,* 441 U.S. at 426. While not affecting the Commission's overall functions, the heavier standard serves to "impress the factfinder with the importance of the decision and thereby perhaps reduce the chances that inappropriate" sanctions will be imposed. *Id.* at 427. Such caution is particularly appropriate where, as here, "the government is threatening to deprive a person of a way of life to which he has devoted years of preparation and on which he and his family have come to rely." Friendly, *Some Kind of Hearing,* 123 U. Pa. L. Rev. 1267, 1297 (1975) (footnote omitted).

To be sure, the SEC is charged with the responsibility of protecting the investing public from deceptive or fraudulent practices on the part of investment advisers. But, as this Court recently noted, Congress provided the Commission with "an arsenal of flexible enforcement powers" to carry out its mission. *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 195 (1976). Importantly, the SEC has wide investigatory authority, and it may seek an injunction in federal court where it has reason to believe that securities violations are about to take place.[11] In addition, the Commission has sought and obtained orders granting far-reaching ancillary relief, greatly enhancing its

[11] Compared to the "mild prophylactic" of an injunction, the sanctions imposed below are extraordinarily severe. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963). Significantly, during the ten years that this matter has been pending, the SEC has not sought an injunction to limit the activities of SSC or Steadman, undermining its contention that debarment is "in the public interest."

remedial function.[12] Moreover, the Commission is expressly empowered to publish information concerning any violations it uncovers, 15 U.S.C. § 78u(a), information that can form the basis of civil actions by injured investors. The SEC has used these and other powers vigorously. *See* Mathews, *Litigation and Settlement of SEC Administrative Enforcement Proceedings,* 29 Cath. U. L. Rev. 215, 221-29 (1980)(hereinafter cited as Mathews).

Thus, the power to discipline investment advisers is simply one of an awesome array of weapons that the SEC has at its disposal. It is a weapon that imposes severe harm upon the individual without vindicating any investor's interest.[13] Here, then, "one party has at stake an interest of transcending value" and the "margin of error [should be] reduced as to him by the process of placing on the other party the burden . . . of persuading the factfinder . . . of his guilt" by a heavier standard of proof. *Speiser* v. *Randall,* 357 U.S. at 525-26; *Addington* v. *Texas,* 441 U.S. at 427.

In contrast to the Fifth Circuit below, the District of Columbia Circuit has squarely held that the Commission must apply the clear and convincing standard of proof in disciplinary

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[12] Such orders have included the appointment of receivers, the large-scale rescission of completed transactions, the imposition of restrictions on business transactions, the requirement of continuing financial reporting beyond that established by the acts, the appointment of special professionals to oversee company dealings, and the reorganization of the management structures and procedures of business and financial enterprises involved in securities laws violations.

Farrand, Ancillary Remedies in SEC Civil Enforcement Suits, 89 Harv. L. Rev. 1779, 1779 (1976).

[13] "SEC sanctions take the form of deprivations. Deterrence, their purpose, is difficult to measure." Case Comment, 93 Harv. L. Rev. 1845, 1856 n.88 (1980). In any case, deterrence is not an appropriate function of SEC disciplinary proceedings. *See* Beck v. SEC, 430 F.2d 673, 675 (6th Cir. 1970).

proceedings. In *Collins Securities Corp.* v. *SEC*, 562 F.2d 820 (D.C. Cir. 1977), the court carefully examined the Commission's contention that the preponderance standard is sufficient because of the "remedial" nature of the proceedings. Noting that "[s]uch labels are likely to reflect conclusions rather than analyses," the court rejected the distinction between "remedial" and "punitive" proceedings as "not determinative." *Id.* at 825.[14] The District of Columbia Circuit, which reviews more disciplinary orders than any other court, found that imposition of the clear and convincing standard of proof in SEC disciplinary proceedings will not impair the Commission's mission of protecting the public "for [the standard] will be used by the agency which is specially charged with such protection, and is able to make an informed appraisal of the significance of evidence concerning securities and markets." *Id.* at 826. Indeed, this observation has been fully borne out by the SEC's post-*Collins* decisions. *See* p. 9 & n.10, *supra*.

The *Collins* court further recognized that "[t]he standard of proof to which the agency is held must in some substantial measure be commensurate with . . . the arsenal of sanctions available to the agency," and concluded that imposition of the clear and co..vincing standard "serves this function of drawing a realistic correlation between the burden of persuasion and the available remedies." 562 F.2d at 826. In *Whitney* v. *SEC*, 604 F.2d 676 (D.C. Cir. 1979), the court reaffirmed *Collins*, holding that the SEC must apply the heavier standard of proof

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[14] The *Collins* court stated as follows:

> From the point of view of the public and enforcement agency, the action of the SEC is "remedial." To the broker removed from his profession the action partakes of "punitive" impact. One would hardly say that removal of a robber from society should be classed as only "remedial," because it protects ordinary citizens from his probable repetition of the crime.

562 F.2d at 825 (footnotes omitted).

in proceedings resulting in a mere nine-month suspension. *Id.* at 681.[15]

In contrast to the reasoned approach of *Collins* and *Whitney,* the court below failed to recognize that hollow references to the SEC's "remedial" function do not obviate the need for affording procedural protections to individuals subject to serious sanctions. This Court has repeatedly warned against such wooden reliance upon semantic labels. *See, e.g., O'Bannon* v. *Town Court Nursing Center,* 48 U.S.L.W. 4842, 4848 (June 23, 1980) (Blackmun, J., concurring); *Addington* v. *Texas,* 441 U.S. at 426-27; *Califano* v. *Westcott,* 443 U.S. 76, 85 (1979). Thus, simply because a proceeding may be characterized as remedial, it may not be used to inflict any manner of harm on an individual "upon no higher degree of proof than applies in a negligence case." *Woodby* v. *Immigration Service,* 385 U.S. 276, 285 (1966).

The inadequacies of the "preponderance of the evidence" standard of proof cannot be remedied, as the court below suggested, by appellate review of SEC disciplinary orders pursuant to an "arbitrary and capricious" standard of review.[16] The "arbitrary and capricious" standard of review would not

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[15] The nine-month suspension in *Whitney* stands in stark contrast to the permanent professional disqualification and forced divestiture imposed on petitioner by the Commission below.

[16] The Fifth Circuit was troubled by the disproportionate severity of the "harsh sanctions" imposed upon petitioner on the basis of largely technical violations. This disproportion was particularly apparent in light of the Commission's express refusal to find that the Funds' custodial accounts had been placed as an inducement for the loans, the undisputed benefits realized by the Funds from the location of the custodial accounts, and the novelty of the Commission's theory that the mere potential for adverse inferences creates a disclosure obligation notwithstanding the absence of wrongdoing. *See* Pet. App. 30; pp. 2-4, *supra.* The court thus remanded to the SEC with instructions "to articulate carefully the grounds for its decision, including an explanation of why lesser sanctions will not suffice." Pet. App. 34.

reduce the likelihood of erroneous determinations of guilt, for guilt established "upon a bare preponderance of evidence . . . leaves the issue in doubt." *Maxwell Land-Grant Case,* 121 U.S. 325, 381 (1887).[17] In addition, the necessity to explain the sanctions does nothing to mitigate the severe stigma associated with a finding that petitioner engaged in securities fraud. *Addington* v. *Texas,* 441 U.S. at 425-26 (higher standard of proof required due to stigma associated with adverse factual finding). *See In re Winship,* 397 U.S. at 374 (Harlan, J., concurring). *See also* p. 20, *infra.*[18] Thus, the "arbitrary and capricious" standard is not an adequate substitute for clear and convincing proof. For persons stigmatized by a finding of fraud

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[17] Mr. Justice Brennan, writing for the Court in In re Winship, 397 U.S. 358 (1970), noted that the preponderance of the evidence standard may be inherently defective in failing to assure that factual determinations even reflect the weight of the evidence:

> [T]he preponderance test is susceptible to the misinterpretation that it calls on the trier of fact merely to perform an abstract weighing of the evidence in order to determine which side has produced the greater quantum, without regard to its effect in convincing his mind of the truth of the proposition asserted.

Id. at 367-68, *quoting* Dorsen & Rezneck, In re Gault and the Future of Juvenile Law, 1 Family L. Quarterly, No. 4, at 1, 26-27 (1967).

[18] In this case, the inflammatory language employed by the SEC imposed the severest possible stigma upon petitioner. The Commission stated as follows: "So egregiously faithless a fiduciary as Steadman cannot be permitted to meddle further with other people's money." Pet. Supp. App. 99-101 (footnotes omitted). Such vitriolic language is particularly inappropriate in view of the uncontroverted evidence that no one had been harmed by petitioner's conduct and the SEC's refusal to find that petitioner had gained any benefit from the alleged violations. Indeed, the Funds were the only ones to benefit from petitioners' allegedly "faithless" conduct. For example, one Fund's account was transferred in 1970 to the National Bank of Washington. Tr. 809, 811, 1128-40; Exhs. J, K, 251. The NBW had made one substantially collateralized loan to Steadman at competitive interest rates. Tr. 718-19. Since 1970, this Fund has realized almost $500,000 in savings from the transfer.

or punished by an SEC order, it is little comfort to know that, pursuant to the Fifth Circuit's formula, the SEC must carefully frame an explanation for the sanctions it imposes based upon an erroneous determination of guilt.

II.

THE CLEAR AND CONVINCING STANDARD OF PROOF MUST BE IMPOSED FOR THE ADDITIONAL REASON THAT THE SEC DISCIPLINARY PROCEEDINGS AGAINST STEADMAN INVOLVED ALLEGATIONS OF FRAUD

In *Addington,* the Court noted that the clear and convincing standard of proof is applied "in civil cases involving allegations of fraud or some other quasi-criminal wrongdoing by the defendant." 441 U.S. at 424. This requirement is imposed because "[t]he interests at stake in those cases are deemed to be more substantial than mere loss of money," for the defendant risks having his reputation tarnished erroneously. By increasing the plaintiff's burden of proof, the risk of an erroneous determination is reduced. *Id.; Woodby* v. *Immigration Service,* 385 U.S. at 285 n.18. In addition, charges of fraud must frequently be proved by inferences drawn from circumstantial evidence, thus increasing the danger of an erroneous determination and making the higher standard of proof a necessary safeguard. *See Collins Securities Corp.* v. *SEC,* 562 F.2d at 824-26.

SEC disciplinary proceedings are squarely governed by these principles. The charges in such proceedings unquestionably involve "allegations of fraud or . . . quasi-criminal wrongdoing." A determination of securities fraud tarnishes the reputation of the accused and seriously impairs his ability to conduct business even if the Commission does not order debarment. In addition, securities fraud cases, like those involving common law fraud, frequently turn on inference and conjecture, particularly involving the accused's state of mind.

See Aaron v. *SEC*, 48 U.S.L.W. 4609, 4613-15 (June 2, 1980), (scienter required under Section 17(a)(1) of the Securities Act of 1933); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. at 194-214 (scienter required under Section 10(b) of the Securities Exchange Act of 1934). SEC disciplinary proceedings "inevitably are subject, in varying degrees, to the uncertainties of circumstantial and subjective proof, and result in stigmatizing the defendant irrespective of the formal sentence meted out." *Whitney* v. *SEC*, 604 F.2d at 681. *Accord, Collins Securities Corp.* v. *SEC*, 562 F.2d at 824-26.

The Fifth Circuit below considered securities fraud to be so different from common law fraud as to render these considerations inapplicable. Pet. App. 25. That conclusion was based on a single premise: because intent to defraud need not be proved to establish a violation of some sections of the securities laws, "violation[s] of these sections . . . are capable of proof by ordinary direct or circumstantial evidence as in any other administrative proceeding." *Id.* That premise is plainly in error. It is absolutely clear that before the SEC may take any action in a disciplinary proceeding, it must first determine the respondent's mental state, even where scienter is not an element of the substantive offense charged. This is because, under this Court's holding in *Aaron*, the enforcement provisions under which the SEC pursues its remedies "modify the substantive provisions at issue . . . so far as scienter is concerned." 48 U.S.L.W. at 4615. *See also SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 192 n.40 (1963).

Section 9(b) of the Investment Company Act and Section 203(f) of the Investment Advisers Act, 15 U.S.C. §§ 80a-9(b), 80b-3(f), pursuant to which these disciplinary proceedings were brought, augment the substantive statutory provisions by requiring the SEC to make two additional determinations: (1) that the violations were "willful,"[19] and (2) that the imposition

[19] Section 9(b) contains the willfulness requirement in each of its three subsections. Section 203(f) incorporates by reference the willfulness requirement of Section 203(e)(4), 15 U.S.C. 80b-3(e)(4).

of sanctions would be "in the public interest."[20] These determinations require heavy reliance upon inferential and subjective evidence, and are *not,* as the Fifth Circuit suggested, "capable of proof by ordinary direct or circumstantial evidence."

The willfulness requirement, by definition, involves an inquiry into petitioner's mental state. Even under the narrowest interpretation of willfulness, the SEC must determine that the accused intended to perform the acts that constitute the offense, and that they were not merely the product of accident, inadvertence, ordinary carelessness or simple negligence.[21] *See Arthur Lipper Corp.* v. *SEC,* 547 F.2d 171, 180 (2d Cir. 1976), *cert. denied,* 434 U.S. 1009 (1978); L. Loss, *Securities Regulation* 3373 (2d ed. Supp. 1969). However, there is strong indication

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[20] The legislative history of these provisions is quite explicit that the SEC may take disciplinary action only upon making these findings:

> The Commission could take such action *only if it found* (1) that the individual in question had willfully violated, or had willfully participated in a violation of any provision of the Securities Act, the Securities Exchange Act, the Investment Company Act or the Investment Advisers Act or any rule or regulation under those statutes; and (2) that the action was in the public interest.

Report of the House Comm. on Interstate & Foreign Commerce, H.R. Rep. No. 1382, 91st Cong., 2d. Sess. 20 (1970); Report of the Senate Comm. on Banking & Currency, S. Rep. No. 1351, 90th Cong., 2d. Sess. 33 (1968) (emphasis added).

[21] Where, as in this case, the allegedly culpable act consists of an omission, *i.e.,* petitioner's failure to make certain disclosures, this requirement becomes much more than a trivial matter. This is particularly true here for, as the SEC has admitted, the violation turned on a question of first impression. Pet. Supp. App. 95 n.87. Moreover, it is totally illogical to assume that Steadman's violations were willful, for he realized no gains from the placement of the custodial accounts, while the benefits to the Funds and their investors —to whom the disclosures allegedly should have been made— were substantial. *See, e.g.,* p. 14, n.18, *supra.*

that Congress intended the willfulness requirement to connote much more, commanding the SEC to establish actual scienter in meeting its burden of proof in disciplinary proceedings. *See Aaron* v. *SEC*, 48 U.S.L.W. at 4612-14;[22] *Whitney* v. *SEC*, 604 F.2d at 682 n.23. *See also* Mathews, 29 Cath. U. L. Rev. at 238-40.[23] Whether one takes a broad or a narrow view, the willfulness requirement, totally ignored by the court below,

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[22] *Aaron* suggests that each Member of the Court, and even the Commission, believes that Congress employs the term " 'willfully' . . . in the securities laws when it want[s] to specify a prerequisite of knowledge or intent." 48 U.S.L.W. at 4616 (Blackmun, J., dissenting); *id.* at 4614-15 (majority opinion). The Commission equated "willfullness" with "intent", arguing that scienter was not required under Section 17(a)(1) of the 1933 Act because the willfulness requirement had been deleted from an earlier draft of that section: "the deliberate elimination of the language of intent reveals that Congress considered and rejected a scienter requirement under all three clauses of § 17(a)." *Id.* at 4614. In contrast, the operative provisions here involved *include* a willfulness requirement. The same logic employed by the Commission and accepted by this Court in *Aaron* forces the conclusion that the term "willful" in Section 9(b) of the Investment Companies Act and Section 203(f) of the Investment Advisers Act also connotes intent or scienter.

[23] State of mind is particularly relevant where, as here, petitioner was charged, *inter alia*, with aiding and abetting violations allegedly committed by SSC. Pet. App. 2 n.1. The D.C. Circuit recently held that in administrative hearings where sanctions may be imposed, a state of mind amounting to more than mere negligence must be shown to establish aider-and-abettor liability. Investors Research Corp. v. SEC, No. 78-1589 (D.C. Cir., Apr. 29, 1980), slip op. at 17-21. Significantly, the D.C. Circuit relied upon a similar decision in the Fifth Circuit, a decision ignored by the panel below. Woodward v. Metro Bank, 522 F.2d 84, 94-97 (5th Cir. 1975) (aider and abettor must have assisted "knowingly and substantially" in the principal violation). Of course, with regard to SSC's loans, the disclosure obligation, if any, would have rested in the first instance on the corporation and the directors approving the loans.

plainly necessitates an inquiry into the accused's mental state akin to that made in common law fraud actions.[24]

The second requirement in disciplinary proceedings compels the SEC to make additional complex factual determinations. Thus, in deciding what is "in the public interest," the SEC considers a variety of factors, the factual basis of which can be determined only by inference, conjecture and subjective judgment. *See* Thomforde, *Patterns of Disparity in SEC Administrative Sanctioning Practice,* 42 Tenn. L. Rev. 465, 473-74 (1975). Indeed, the SEC itself has taken the position that "the state of mind of the participants" is a major factor in determining what sanctions are "in the public interest."[25] As amply demonstrated by the SEC's opinion in this case, this determination is based largely upon inference and conjecture. Pet. Supp. App. 95-103. *See Beck* v. *SEC,* 430 F.2d 673, 674-75 (6th Cir. 1970).[26] Thus, the Fifth Circuit's unsubstantiated assertion that SEC disciplinary proceedings involve no inferential proof — its only stated basis for refusing to follow the D.C. Circuit's reasoned approach in *Collins* and *Whitney*—does not survive close examination.

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[24] Steadman did not testify in the administrative hearing. Thus, the Commission's findings of willfulness were based on what the Fifth Circuit termed "only the coincidence that Steadman and SSC borrowed from the funds' custodians." Pet. App. 30. Inference and conjecture were therefore inherent in the Commission's reasoning process.

[25] The Fifth Circuit recognized this in its opinion:

> We heartily endorse the Commission's view that while scienter is not required to make out violations of several of the statutory sections involved here, the respondent's state of mind is highly relevant in determining the remedy to impose.

Pet. App. 29.

[26] Moreover, SEC disciplinary proceedings frequently involve a plethora of substantive charges, some of which require a separate showing of scienter. Thus, petitioner was charged, *inter alia,* with violating Sections 10(b) and 17(a)(1), both of which have been held to require scienter.

As this Court recognized in *Addington*, clear and convincing proof has been required in cases involving allegations of fraud because a finding of fraud stigmatizes the defendant, causing him harm beyond mere loss of money. 441 U.S. at 424.[27] The Fifth Circuit dismissed this argument, treating *Addington* as mere dictum. Yet it is quite clear that, like common law fraud, a finding of securities fraud causes enormous harm to the accused, regardless of whether sanctions are actually imposed. *Whitney* v. *SEC*, 604 F.2d at 681. Indeed, courts have expressly held that violations of federal or state securities laws "are contrary to the concept of honesty and good morals" and involve "the stigma of moral turpitude." *In re Hatch*, 10 Cal. 2d 147, 152, 73 P.2d 885, 887 (1937). *Accord, In re Murphy*, 15 Cal. 3d 533, 542 P.2d 12, 125 Cal. Rptr. 276 (1975); *Cincinnati Bar Association* v. *Shott*, 10 Ohio St. 2d 117, 226 N.E.2d 724 (1967). This severe additional harm to persons charged with securities fraud, and the necessity to rely on inferential evidence in establishing the violation, require application of the clear and convincing standard of proof.

III.

IMPOSITION OF THE CLEAR AND CONVINCING STANDARD OF PROOF IN SEC DISCIPLINARY PROCEEDINGS ACCORDS WITH PRECEDENT AND THE INTENT OF CONGRESS

In a series of recent decisions, this Court has sought to protect individuals from unwarranted deprivation of valuable rights by requiring that the proof against them be greater than the "mere preponderance of the evidence." *Addington* v. *Texas*,

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[27] *See, e.g.*, Weininger v. Metropolitan Fire Ins. Co., 359 Ill. 584, 598, 195 N.E. 420, 426 (1935); Bank of Pocahontas v. Ferimer, 161 Va. 37, 41, 170 S.E. 591, 592 (1933); Bowe v. Gage, 127 Wis. 245, 251, 106 N.W. 1074, 1076 (1906). *See also*, Kaplan, Decision Theory and the Factfinding Process, 20 Stan. L. Rev. 1065, 1072 (1968).

441 U.S. at 423. In *Addington* the clear and convincing standard was held applicable in civil commitment proceedings. *See also Mullaney* v. *Wilbur,* 421 U.S. 684 (1975) (beyond a reasonable doubt standard applicable in criminal proceedings); *Rosenbloom* v. *Metromedia, Inc.,* 403 U.S. 29, 50-52 (1971) (clear and convincing standard applicable in defamation action that implicates First Amendment rights); *In re Winship,* 397 U.S. at 368 (beyond a reasonable doubt standard applicable in proceedings to determine juvenile delinquency); *Woodby* v. *Immigration Service,* 385 U.S. at 285-86 (clear and convincing proof standard applicable in deportation proceedings); *Schneiderman* v. *United States,* 320 U.S. 118, 125 (1943) (clear and convincing proof standard applicable in denaturalization proceedings); *Chaunt* v. *United States,* 364 U.S. 350, 353 (1960) (same). These cases reflect the Court's judgment that where important personal rights are at stake, "[t]he individual should not be asked to share equally with society the risk of error." *Addington,* 441 U.S. at 427.

Petitioner's rights here in jeopardy are indistinguishable from those for which this Court has expressed special solicitude. Petitioner has a constitutionally protected interest in practicing his profession. *See Hampton* v. *Mow Sun Wong,* 426 U.S. 88 (1976); *In re Ruffalo,* 390 U.S. 544 (1968); *Ex parte Wall,* 107 U.S. (17 Otto) 265, 289 (1882); *Kivitz* v. *SEC,* 475 F.2d 956, 962 (D.C. Cir. 1973). He has a separate constitutional interest in his reputation, which this Court has repeatedly recognized as a highly valuable asset. For example, *Michelson* v. *United States,* 335 U.S. 469 (1948), noted that evidence of good character alone may be sufficient to raise a reasonable doubt as to criminal culpability.[28] Moreover, the finding of fraud will

[28] Importantly, the courts of appeals have vigorously applied this principle to SEC disciplinary proceedings, reversing findings of misconduct where the accused was able to point to a previously unblemished reputation and record for handling investors' funds. *See, e.g.,* Klopp v. SEC, 427 F.2d 455 (6th Cir. 1970); Kivitz v. SEC, 475 F.2d 956 (D.C. Cir. 1973). The evidence at the hearing conclusively established petitioner's distinguished and previously unblemished record.

affect petitioner's standing in the community and may impair his ability to obtain other employment. *See* p. 20, *supra. Compare, Bishop* v. *Wood,* 426 U.S. 341, 348 (1976); *Paul* v. *Davis,* 424 U.S. 693, 701 (1976).

The risk of such harm is particularly acute where, as here, the finding is based on "inferences . . . dependent on the exercise of discretion by an administrative agency and not a court." *Collins Securities Corp.* v. *SEC,* 562 F.2d at 823. *See* pp. 17-19, *supra.* [29] Because the agency performs both prosecutorial and adjudicatory functions, it may lack total objectivity. Courts have therefore shown particular concern for procedural safeguards where administrative action results in the impairment of protected interests. *See Environmental Defense Fund, Inc.* v. *Ruckelshaus,* 439 F.2d 584, 597-98 (D.C. Cir. 1971).[30] In a particularly applicable passage, Professor Jaffe noted:

> In situations when individuals stand to suffer serious liabilities as a consequence of administrative action, justice may be served by demanding increased procedural protections. One begins with the fact that *in certain respects administrative procedures are less solicitous of the protections of the individual than are civil or criminal procedures. For this reason it may be appropriate in some cases to impose greater burdens of proof, and/or more thoroughgoing judicial review.*

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[29] This problem is aggravated in this case by the failure of the SEC to promulgate, either informally or by formal rule, substantive standards for disciplinary proceedings or administrative sanctions. *See* Case Comment, 93 Harv. L. Rev. at 1855 & n.82. *See also* Pet. App. 28 n.18.

[30] This Court "repeatedly has emphasized that 'procedural due process rules are shaped by the risk of error inherent in the truth-finding process . . . .' *Mathews* v. *Eldridge,* 424 U.S. 319, 344 (1976)." Carey v. Piphus, 435 U.S. 247, 259 (1978) (footnote omitted).

Jaffe, *Administrative Law: Burden of Proof and Scope of Review,* 79 Harv. L. Rev. 914, 919-20 (1966) (emphasis added).[31]

In gauging the weight of these considerations, it should be noted that Congress has not expressly provided a standard of proof for SEC disciplinary proceedings. Where Congress has not spoken, the federal courts have consistently supplied the standard of proof that is appropriate in light of the interest at stake. *Vance* v. *Terrazas,* 100 S. Ct. 540, 547-48 (1980), citing as an example *Nishikawa* v. *Dulles,* 356 U.S. 129, 135 (1958) (clear and convincing proof required in expatriation proceedings). *See also, e.g., United States* v. *Foster Wheeler Corp.,* 447 F.2d 100, 101 (2d Cir. 1971) (clear and convincing proof required for civil liability under the False Claims Act).

Congressional silence in this instance connotes more, however, than simple deference to this Court's prospective judgment; it constitutes an affirmative intention to ensure the higher standard of proof. The statutory provisions pursuant to which sanctions were imposed were enacted as part of the Investment Company Amendments Act of 1970. Pub. L. 91-547, 84 Stat. 1413. In determining congressional intent, these provisions "must be interpreted in the light of the common law and scheme of jurisprudence existing at the time of [their] enactment." 2A J. Sutherland, *Statutory Construction* § 50.01, at 268 (4th ed. 1973). Two separate lines of common law authority support the application of the clear and convincing standard of

[31] The proceedings in this case underscore these concerns. For example, petitioner argued to the Commission that the Administrative Law Judge's 136 page opinion was in substantial part a duplicate of the brief submitted by the Division of Enforcement. *See* Br. of Resp. in Support of Pet. for Review 90-91 (Mar. 17, 1975). The Commission dismissed this and similar concerns in a scant footnote, terming them "baseless." Pet. Supp. App. 96 n.88. This offhand treatment evidences a disturbing lack of sensitivity to the seriousness of this issue.

proof in SEC disciplinary proceedings. The first consists of cases dealing with the standard of proof applicable to proceedings imposing disciplinary sanctions upon attorneys. The great weight of authority in the state and federal courts holds that such discipline may be imposed only upon a showing of clear and convincing proof. *See, e.g., In re Fisher,* 179 F.2d 361, 369-70 (7th Cir.), *cert. denied,* 340 U.S. 825 (1950) (disbarment); *In re Ryder,* 263 F. Supp. 360, 361 (E.D. Va.) (disbarment), *aff'd,* 381 F.2d 713 (4th Cir. 1967); *In re Pennica,* 36 N.J. 401, 419, 177 A.2d 721, 730 (1962) (disbarment); *Golden* v. *State Bar,* 213 Cal. 237, 247, 2 P.2d 325, 329 (1931).[32]

The second line of authority pertains to cases involving allegations of fraud. As discussed above, the clear and convincing standard of proof "has traditionally been imposed in cases involving allegations of civil fraud." *Woodby* v. *Immigration Service,* 385 U.S. at 285 n.18. *See Saenz* v. *Kenedy,* 178 F.2d 417, 419 (5th Cir. 1949) (fraud "must always be proven by clear and convincing evidence"); 9 J. Wigmore, *Evidence* § 2498, at 329 (3d ed. 1940) (" 'clear and convincing proof' is commonly applied to measure the necessary persuasion for a charge of fraud"). *See also* p. 15, *supra.* More importantly, this and other federal courts have consistently interpreted congressional enactments setting fraud as a standard as importing a requirement of clear and convincing proof. *See, e.g., United States* v. *American Bell Telephone Co.,* 167 U.S. 224, 251 (1897) (action to set aside patent on grounds of fraud); *Maxwell Land-Grant Case,* 121 U.S. 325, 381 (1887) (action to set aside federal land grant on ground that it was issued on

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[32] *See also* In re Berlant, 458 Pa. 439, 441, 328 A.2d 471, 473 (1974) (5 year suspension), *cert. denied,* 421 U.S. 964 (1975); In re Sears, 71 N.J. 175, 197, 364 A.2d 777, 788-89 (1976) (3 year suspension); In re Myrland, 43 Ariz. 126, 128, 29 P.2d 483, 483 (1934); State v. Shumate, 48 W. Va. 359, 364, 37 S.E. 618, 620 (1900); In re Wright, 131 Vt. 473, 489, 310 A.2d 1, 9-10 (1973) & cases cited; In re Gladstone, 28 F. Supp. 858, 860 (S.D.N.Y. 1939).

basis of false representations); *United States* v. *Foster Wheeler Corp.*, 447 F.2d 100, 101 (2d Cir. 1971) (where False Claims Act sets substantive standard of "false, fictitious or fraudulent . . . the law supplies the requirement of clear and convincing proof"); *Lessman* v. *Commissioner*, 327 F.2d 990, 993 (8th Cir. 1964) (in interpreting § 7454(a) of the Internal Revenue Code "[c]ourts have often stated that the Government must establish fraud by clear and convincing evidence").

Congress plainly was aware of these established lines of authority when it enacted the 1970 legislation giving the Commission broad new powers to impose disciplinary sanctions. Had it been dissatisfied with that standard, it would have specified a different one, as it has done on occasion. *See, e.g., Vance* v. *Terrazas*, 100 S. Ct. at 548.[33] Indeed, when Congress has expressly provided a standard of proof, it has been *in derogation* of the standard it knew would be imposed under established common law principles. *See, e.g., Vance* v. *Terrazas, supra; Rogers* v. *Missouri Pacific R.R.*, 352 U.S. 500, 507 (1957) (relaxed evidentiary standard imposed under FELA "because the Congress was dissatisfied with the common law duty of the master to his servant").[34]

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[33] *Terrazas* addressed 8 U.S.C. § 1481 which provides that voluntary acts of expatriation may be proved by a preponderance of the evidence. This Court noted that by articulating a standard in the statute, Congress intended to alter the common law standard of clear and convincing proof for expatriation cases: "its evident aim was to supplant the evidentiary standards prescribed by *Nishikawa.*" 100 S. Ct. at 547. *See* p. 23, *supra.*

[34] Similarly, Congress has raised the standard of proof in circumstances where it has deemed the likely common law standard not sufficiently demanding. Thus, in child custody proceedings and proceedings to terminate parental rights of Indian children, Congress imposed a higher standard than that provided by the common law. *See* Indian Child Welfare Act of 1978, 25 U.S.C. § 1912(e) (clear and convincing evidence standard applicable to custody proceedings);

(footnote continues)

Particularly telling is a series of congressional enactments establishing the standard of proof in quasi-criminal proceedings similar in material respects to the disciplinary proceedings against petitioner. *See, e.g.*, 18 U.S.C. § 4214(d) (parole revocation); 21 U.S.C. § 849 (classification as "dangerous special drug offender" for purposes of sentencing); 41 U.S.C. § 39 (contempt); 50 U.S.C. § 973 (classification as communist action organization). In each instance, Congress reasonably anticipated that, absent congressional direction, federal courts applying common law principles would have imposed a heightened standard of proof.[35] To avoid this, Congress carefully specified in each case that the preponderance of the evidence standard was applicable. Congress' failure to include such a provision in the statute governing SEC disciplinary proceedings raises the strong inference that it expected and intended the courts to incorporate the common law standard requiring clear and convincing proof.

This inference is greatly strengthened by recent developments. Congress has failed to respond to SEC requests that it displace the clear and convincing standard in SEC enforcement proceedings. In July 1979, the SEC filed a memorandum with the Senate Governmental Affairs Committee opposing two regulatory reform bills (S.262 and S.755) unless they were amended to overrule *Collins* by specifically providing a pre-

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(footnote continued)

§ 1912(f) (proof beyond a reasonable doubt standard applicable to parental right termination proceedings). The common law had required only a preponderance of the evidence. *E.g.*, In re S., 26 Or. App. 219, 552 P.2d 578 (1976); In re R.E.W., 545 S.W.2d 573 (Tex. Civ. App. 1976). *See also, e.g.*, 29 U.S.C. § 722(c) (non-eligibility for vocational rehabilitation services must be supported by proof beyond a reasonable doubt).

[35] For example, the common law standard of proof for civil contempt proceedings is "clear and convincing evidence." *E.g.*, Coca-Cola Co. v. Feulner, 7 F. Supp. 364, 365 (S.D. Tex. 1934). To ensure a lower burden in contempt proceedings involving public contract matters, Congress supplanted this standard by explicitly providing for proof "by the preponderance of the evidence." 41 U.S.C. § 39.

ponderance of the evidence standard of proof in all SEC adjudicatory proceedings. *Memorandum of the Securities and Exchange Commission: Hearings on S.262 and S.755 Before the Senate Comm. on Governmental Affairs,* 96th Cong., 1st Sess. 1283, 1325 (1979). Congress has not amended that legislation in response to the SEC's request.

Even more important, within the last year both the House and the Senate have embraced the clear and convincing standard of proof in rules governing hearings of alleged misconduct by their members. *See* House Committee on Standards of Official Conduct, Rules of Procedure, 125 Cong. Rec. H1638, 1640 (daily ed. March 22, 1979); In the Matter of Representation of Representative Charles H. Wilson, 126 Cong. Rec. H4691, 4693-94 (daily ed. June 10, 1980); Senate Select Committee on Ethics, 96th Cong., 2d Sess., Report on Investigation of Senator Herman E. Talmadge 84 (Comm. Print 1980). These hearings are virtually indistinguishable from the disciplinary proceedings below: they generally involve allegations of fraud or other wrongdoing carrying a stigma of moral turpitude; the evidence presented is frequently of an inferential or subjective character; and there is a possibility that serious sanctions, ranging from censure to expulsion, will be imposed. These provisions evidence strong congressional approval of the clear and convincing standard of proof in disciplinary proceedings of the type undertaken against petitioner.

CONCLUSION

As the Court noted in *Addington,* " [i]n cases involving individual rights, whether criminal or civil, '[t]he standard of proof [at a minimum] reflects the value society places on individual liberty.' " 441 U.S. at 425. There can be little doubt that if the Commission's ruling were allowed to stand, it would inflict grievous harm upon petitioner. However, the alleged wrongdoing has been found here by the thinnest margin known to the law. The preponderance of the evidence standard does

not properly reflect the serious burden placed upon petitioner by the risk of erroneous adjudication — a substantial risk here due to the frailty of a reasoning process dependent upon inference and conjecture. Imposition of the higher standard of proof will not affect "the informality, flexibility, or speed of the hearing," *In re Winship,* 397 U.S. at 366; and the Commission has demonstrated that the clear and convincing standard does not hamper its efforts to enforce the securities laws. Requiring clear and convincing proof will simply ensure that before imposing severe sanctions upon petitioner, the SEC be more confident of "the correctness of [its] factual conclusions." *Id.* at 370 (Harlan, J., concurring).

The judgment below should be reversed. The Court should direct the dismissal of all allegations against petitioner in light of the pendency of this action for almost ten years during which time Steadman has been stigmatized and his business dealings have been clouded by the SEC's opinion and order.

Respectfully submitted,

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July 1980

APPENDIX

Section 9(b) of the Investment Company Act, 15 U.S.C. § 80a-9(b).

(b) The Commission may, after notice and opportunity for hearing, by order prohibit, conditionally or unconditionally, either permanently or for such period of time as it in its discretion shall deem appropriate in the public interest, any person from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter, if such person —

(1) has willfully made or caused to be made in any registration statement, application or report filed with the Commission under this subchapter any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such registration statement, application, or report any material fact which was required to be stated therein; or

(2) has willfully violated any provision of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of subchapter II of this chapter, or of this subchapter, or of any rule or regulation under any of such statutes; or

(3) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of subchapter II of this chapter, or of this subchapter, or of any rule or regulation under any of such statutes.

Section 203(e) & (f) of the Investment Advisers Act, 15 U.S.C. § 80b-3(e) & (f).

(e) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any investment adviser if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such investment adviser, or any person associated with such investment adviser, whether prior to or subsequent to becoming so associated —

(1) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this subchapter, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein.

(2) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any felony or misdemeanor which the Commission finds — (A) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, or conspiracy to commit any such offense; (B) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, investment adviser, bank, insurance company, or fiduciary; (C) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities; or (D) involves the violation of section 152, 1341, 1342, or 1343 or chapter 25 or 47 of title 18.

(3) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, or municipal securities dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

(4) has willfully violated any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, subchapter I of this chapter, this subchapter, or the rules or regulations under any of such statutes or any rule of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

(5) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, subchapter I of this chapter, this subchapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this paragraph (5), no person shall be deemed to have failed reasonably to supervise any person, if

(A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other persons, and

(B) such person has reasonably discharged the duties and obligations incumbent upon him by reason

of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

(6) is subject to an order of the Commission entered pursuant to subsection (f) of this section barring or suspending the right of such person to be associated with an investment adviser which order is in effect with respect to such person.

(f) The Commission, by order, shall censure or place limitations on the activities of any person associated or seeking to become associated with an investment adviser, or suspend for a period not exceeding twelve months or bar any such person from being associated with an investment adviser, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act or omission enumerated in paragraph (1), (4), or (5) of subsection (e) of this section, or has been convicted of any offense specified in paragraph (2) of said subsection (e) within ten years of the commencement of the proceedings under this subsection, or is enjoined from any action, conduct, or practice specified in paragraph (3) of said subsection (e). It shall be unlawful for any person as to whom such an order suspending or barring him from being associated with an investment adviser is in effect willfully to become, or to be, associated with an investment adviser without the consent of the Commission, and it shall be unlawful for any investment adviser to permit such a person to become, or remain, a person associated with him without the consent of the Commission, if such investment adviser knew, or in the exercise of reasonable care, should have known, of such order.

Supreme Court, U. S.
FILED
AUG 15 1980
MICHAEL RODAK, JR., CLERK

No. 79-1266

In the Supreme Court of the United States

OCTOBER TERM, 1979

CHARLES W. STEADMAN, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

QUESTION PRESENTED

Whether, in an administrative proceeding before the Securities and Exchange Commission, violations by a fiduciary of antifraud provisions of the federal securities laws must be proven by clear and convincing evidence, rather than by a fair preponderance of the evidence.

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The opinion of the court of appeals (Pet. App. 1-34) is reported at 603 F.2d 1126. The opinion of the Securities and Exchange Commission (Supp. App. 1-122) is reported at 12 S.E.C. Docket 1041.

JURISDICTION

The judgment of the court of appeals (Pet. App. 35) was entered on October 4, 1979. A petition for rehearing was denied on November 27, 1979. The petition for a writ of certiorari was filed on February 15, 1980, and was granted on April 28, 1980. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant statutory provisions are set forth in the Appendix to this brief.

STATEMENT

This case concerns the standard of proof employed by the Securities and Exchange Commission in an administrative proceeding brought against petitioner Steadman, the president, chairman of the board of directors and sole owner of an investment adviser serving several mutual funds registered with the Commission under the Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.* Petitioner is also the sole owner of several broker-dealer firms registered with the Commission under the Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.* After an administrative hearing, the Commission found by a preponderance of the evidence that petitioner had committed numerous violations of the federal securities laws. On review, the court of appeals upheld the Commission's use of that standard of proof in this administrative context.

1. The Regulatory Scheme

The federal securities laws contain several provisions empowering the Securities and Exchange Commission to impose sanctions on fiduciaries who have deviated from the standards imposed on them by Congress. Under Section 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*(b), the Commission may impose any of a specified range of sanctions on brokers or dealers and associated persons, including censure, curtailment of activities, and suspension or revocation of registration. The Commission may impose such sanctions if it finds, on the record and after notice and an opportunity for a hearing, that the sanctions are in the public interest and that the respondent has, *inter alia*, willfully violated or aided and abetted a violation of the federal securities laws. Section 203 of the Investment Advisers Act of 1940, 15 U.S.C. 80b-3, vests the Commission with comparable authority to impose sanctions on investment advisers and associated persons. Sanctions ranging from censure to revocation of the registration of the adviser may be imposed.[1] Similarly, Section 9(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-9(b), authorizes the Commission to prohibit persons who have willfully committed securities law violations from being associated with a registered investment company, either permanently or for a specified period of time, and to impose other sanctions on such persons as it deems appropriate in the public interest.[2]

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[1] These sanctions may be imposed based on the willful filing with the Commission of a misleading report or application for registration, on a criminal conviction in certain categories of cases, on the entry of specified injunctive orders, on willful violations of the federal securities laws or inability to comply therewith, or on willful aiding and abetting of violations of the federal securities laws. 15 U.S.C. 80b-3(e), (f).

[2] These sanctions may be imposed based on the willful filing with the Commission of a misleading registration statement,

Every respondent in an administrative proceeding brought pursuant to these statutory provisions enjoys procedural protections designed to assure a fair hearing and an accurate determination of factual questions. These protections are guaranteed by the Administrative Procedure Act, 5 U.S.C. 551 *et seq.*, and the Commission's Rules of Practice, 17 C.F.R. 201.1 *et seq.*, which enlarge the rights prescribed under the Administrative Procedure Act. Thus, a respondent is entitled to receive timely notice of the charges against him and the questions of fact and law to be determined (17 C.F.R. 201.6 (a)). He may retain counsel to represent him in connection with the proceeding (17 C.F.R. 201.2(b)), file an answer to the charges against him and move for a more definite statement of those charges (17 C.F.R. 201.7 (d)), and have a trial-type hearing presided over by an impartial administrative law judge (17 C.F.R. 201.11 (b)-(c)). The respondent may present oral or documentary evidence, cross-examine adverse witnesses, and object to the admission or exclusion of evidence (17 C.F.R. 201.14(a)). The Commission's rules provide that "[e]very party shall have the right to present such oral or documentary evidence and to conduct such cross-examination as may be required for a full and true disclosure of the facts" (*ibid.*). Subpoenas are available for the production of evidence (17 C.F.R. 201.14(b)), and witness statements in the possession of the Commission's staff may be requested for cross-examination purposes (17 C.F.R. 201.11.1). The "burden of proof" in such a hearing rests on the Commission's staff. 5 U.S.C. 556(d). At the completion of the hearing, the respondent has the right to submit briefs and proposed findings of fact and conclusions of law (17 C.F.R. 201.16(d)). The initial decision of the administrative law judge must include findings of fact and conclusions of law, with sup-

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application or report, on willful violations of the federal securities laws, or on willful aiding or abetting of violations of the federal securities laws. 15 U.S.C. 80a-9(b).

porting reasons, on all material issues of fact, law, or discretion presented on the record (5 U.S.C. 557(c); 17 C.F.R. 201.16(a)).

A respondent adversely affected by an initial decision of an administrative law judge may file a petition for review by the Commission (17 C.F.R. 201.17). Based on briefs, oral argument, the transcribed record, and any additional evidence presented, the Commission may reverse, affirm, or modify the initial decision of the administrative law judge based on its independent review of the record (17 C.F.R. 201.17(g)(2), 201.21). The Administrative Procedure Act provides that "[a] sanction may not be imposed * * * except on consideration of the whole record or those parts thereof cited by a party and supported by and in accordance with the reliable, probative, and substantial evidence" (5 U.S.C. 556(d)).

After exhausting his administrative remedies, a respondent has the right to file a petition for review of the Commission's decision in a court of appeals. The reviewing court has authority to affirm, modify or set aside the Commission's order, in whole or in part, and may also remand the proceeding to the Commission to receive additional evidence. A Commission order may be set aside by the court of appeals if it is unsupported by substantial evidence, if there has been a prejudicial departure from a procedure required by law, or if the order is arbitrary, capricious, or an abuse of discretion (5 U.S.C. 706(2)(A), (D), (E)).

2. The Proceeding Against Petitioner

In June 1971, the Commission instituted an administrative proceeding against petitioner and certain of his wholly owned companies, including Steadman Securities Corporation ("SSC"), an investment adviser registered with the Commission, and Republic Securities Corporation ("RSC"), a broker-dealer registered with the Commission. The administrative order initiating the proceeding alleged violations of numerous provisions of the federal securities laws resulting from petitioner's manage-

ment (through his wholly owned companies) of several mutual funds ("the Funds") registered under the Investment Company Act.[3]

After a lengthy evidentiary hearing, the Commission found that, over a seven-year period ranging from December 1965 to at least June 1972, petitioner repeatedly had violated antifraud,[4] reporting,[5] conflict of interest,[6] and proxy[7] provisions of the federal securities laws. Those violations included petitioner's willful concealment from the Funds' shareholders and directors of his practice of obtaining badly needed loans for himself and his companies at the same banks to which he caused the Funds to transfer, or in which he caused them to maintain, large cash deposits in non-interest-bearing checking accounts (Supp. App. 21-41).

From 1965 to 1968, the Funds maintained checking accounts at the Riggs National Bank in Washington, D.C. In 1968, petitioner's investment adviser firm (SSC) began an expansion program to acquire management rights for additional mutual funds. To finance these

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[3] At its height, petitioner's investment advisory organization had some $250 million of investor assets under management (Supp. App. 21).

[4] Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a); Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5; Section 206(1) and (2) of the Investment Advisers Act, 15 U.S.C. 80b-6(1) and (2).

[5] Section 17(a) of the Securities Exchange Act, 15 U.S.C. 78q(a), and Rule 17a-5 thereunder, 17 C.F.R. 240.17a-5; Sections 30(a) and 34(b) of the Investment Company Act, 15 U.S.C. 80a-29(a) and 80a-33(b).

[6] Sections 15(a)(1), 17(a) and 17(e) of the Investment Company Act, 15 U.S.C. 80a-15(a)(1), 80a-17(a), and 80a-17(e).

[7] Section 20(a) of the Investment Company Act, 15 U.S.C. 80a-20(a).

acquisitions, SSC applied to Riggs for a $2 million loan. Riggs turned down the request. Petitioner then arranged a $3 million loan for SSC from the Chase Manhattan Bank in New York. While the Chase loan was being negotiated, petitioner recommended to the directors of several of the mutual funds that the Funds should transfer their bank accounts to Chase. The directors were told that Chase's fees were lower than Riggs' and that there had been "problems" with Riggs. The directors were not told about the Chase loan to SSC. The directors thereafter approved the transfer of the Funds' bank accounts (Pet. App. 3-4).

Subsequently, Riggs called its personal loans to petitioner, who then obtained a covering loan from the First National Bank of Washington. That loan was also called and petitioner was forced to negotiate a 90 day extension. Two days later, one of the Funds that petitioner managed purchased a 90 day certificate of deposit from First National in an amount larger than petitioner's loan (Pet. App. 4-5). To repay his loan to First National, petitioner obtained yet another loan from the National Bank of Washington. Shortly thereafter, bank accounts for one of the Funds were transferred to that bank from St. Louis. The directors of the Fund were not told about the loan to petitioner when they approved the transfer. None of the loans to petitioner and his corporations was disclosed in the mutual funds' prospectuses (*ibid.*).

In analyzing these transactions, the Commission observed (Supp. App. 26-28; footnotes omitted):

> [I]t would, we think, have been obvious to anyone (let alone someone with Steadman's extensive legal and financial experience) that the banking relationships were of considerable moment to anyone trying to formulate rational decisions about the investment merits of the Steadman-managed funds. Steadman had a self-interest in cultivating and mollifying the banks from which he borrowed. That self-interest [could have] led him to keep unduly large sums un-

> necessarily idle in checking accounts to the banks' benefit but to the funds' detriment.[8]

The Commission also found that petitioner willfully concealed these material facts and "intended to deceive" (Supp. App. 50-53). It added that his "systematic, calculated and protracted concealment of his collateral banking relationships is enough in itself to brand him an unfit manager of other people's money" (*id.* at 52-53).

The record disclosed other repeated and flagrant statutory violations. Petitioner was found to be responsible for the late filing of required annual reports for three of the Funds in three consecutive years. The Commission noted that "[i]n many instances the reports were filed so late as to be of minimal value in serving the purposes intended by the requirements for filing the reports" (Supp. App. 78). In fact, no reports at all were filed during 1971 (*id.* at 78 n.67). Petitioner, who had received repeated warnings from his auditors about related deficiencies (*id.* at 82), nonetheless "chose to save money" by "flout[ing] basic regulatory requirements" (*id.* at 83).[9]

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[8] The Commission found it unnecessary to determine whether petitioner actually used the banking accounts as a *quid pro quo* for the loans made to him and his companies. Rather, the Commission concluded (Supp. App. 28) that, regardless of the connection between the loans and the transfer of the banking accounts, petitioner "had disabled himself from looking at the funds' checking account balances in a wholly disinterested way, with an eye single to the funds' best interests." Under these circumstances, petitioner was required to disclose his serious conflicts of interest. The Commission added that "it is hard to believe that there was no link at all between the funds' deposits and the benefits to Steadman" (Supp. App. 38-39 n.15).

[9] The Commission added that "[t]he matter would be serious enough if we were dealing only with the respondents' failure to file their own reports. But there is much more to it than that. Many of the reports involved were due not

The Commission also found that petitioner had willfully violated, or willfully aided and abetted violations of, various provisions of the Investment Company Act intended to prevent self-dealing and conflicts of interest. For example, petitioner arranged for SSC to defer repayment to the Funds of $260,000 in excess advisory fees that it had received from the Funds (Supp. App. 67-73). The Commission found that "SSC very much wanted to hold on to the money that it was supposed to return to the investment companies" (*id.* at 70) and paid the Funds an unfairly low interest rate (*id.* at 71). The Commission also found that these self-dealing transactions had been concealed (*id.* at 72). Similarly, the Commission found that petitioner had caused his brokerage firm (RSC) to accept and retain certain tender solicitation fees that rightfully belonged to the Funds (*id.* at 73-77).[10]

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from them but from their investment company clients. They were under fiduciary and contractual duties to those clients to file the reports on time" (Supp. App. 85).

[10] In summary, the Commission found that (i) petitioner violated antifraud, proxy, and reporting provisions by failing to disclose the bank loans (Supp. App. 33-41); (ii) RSC, aided and abetted by SSC and petitioner, wrongfully accepted and retained solicitation fees paid by tender offerors to soliciting brokers for the tender of securities held by the Funds in violation of Section 17(e) of the Investment Company Act, 15 U.S.C. 80a-17(e) (Supp. App. 73-77); (iii) SSC violated Section 15(a)(1) of the Investment Company Act, 15 U.S.C. 80a-15(a)(1), by failing promptly to remit to the Funds excess advisory fees (Supp. App. 67-71); (iv) petitioner and SSC violated various antifraud and reporting provisions by failing to disclose to shareholders of the Funds that SSC had retained these excess fees (Supp. App. 72-73); (v) petitioner and SSC aided and abetted violations of Section 17(a) of the Investment Company Act, 15 U.S.C. 80a-17(a), by causing certain of the Funds to buy securities from and sell securities to other Funds (Supp. App. 85-94); and (vi) petitioner, SSC, and its subsidiaries violated Section 30(a) of the Invest-

In light of petitioner's continuing "deceit" and "reckless disregard of applicable filing requirements" (Supp. App. 95)—conduct that showed that he was a "faithless fiduciary" (*id.* at 99)—the Commission determined that petitioner should be barred from association with any investment adviser or registered investment company and also should be suspended for one year from association with any broker or dealer in securities (*id.* at 99-113). The Commission explained that its debarment order was subject to "modification" in the future if petitioner made a showing entitling him to relief (*id.* at 119-120 n.100).[11]

In making the factual findings that supported its order in this case, the Commission used the preponderance of the evidence standard of proof (Supp. App. 97-99 n.88). It noted that "in remedial proceedings of this character a preponderance of the evidence is sufficient to establish the truth of an allegation" (*ibid.*).

3. The Decision of the Court of Appeals

Petitioner sought review of the Commission's decision in the United States Court of Appeals for the Fifth

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ment Company Act, 15 U.S.C. 80a-29(a), and Section 17(a) of the Securities Exchange Act, 15 U.S.C. 78q(a), by failing to file timely reports (Supp. App. 78-85).

[11] In explaining the relative severity of its order, the Commission stated that "[w]hen the misconduct is as egregious as it is in this case, we must take effective measures to protect investors and the public interest from future harm * * *." It added that "[l]eniency in a case of this character is bound to encourage irresponsibility, cavalier attitudes toward basic disclosure obligations, and disregard for inconvenient filing requirements" (Supp. App. 98-99). Nevertheless, the Commission gave petitioner 90 days in which to divest his stock interests in the respondent companies, a period of time that it found to be sufficient to locate a buyer and avoid an economic loss (*id.* at 114). Compliance with the Commission's order has been stayed for over three years pending completion of judicial review.

Circuit, contending, *inter alia*, that the Commission was required to utilize the clear and convincing evidence standard of proof rather than the preponderance of the evidence standard in evaluating the record. The court of appeals rejected that contention (Pet. App. 26). In holding that proof by a preponderance of the evidence was sufficient, the court declined to follow *Collins Securities Corp.* v. *SEC*, 562 F.2d 820, 824 (D.C. Cir. 1977), which had required the clear and convincing evidence standard in a Commission proceeding. Instead of following *Collins*, the court of appeals applied the analysis set forth by this Court in *Addington* v. *Texas*, 441 U.S. 418, 423-433 (1979). Pursuant to *Addington*, it weighed the respective interests of the parties to arrive at the proper allocation of the risk of factual error (Pet. App. 26):

> Balanced against the risk to Steadman is the risk that the investing public will be inadequately protected. The public interest in high standards of conduct in the securities business is a great one. If the burden of proof imposed on the Commission is too high, its ability to police the industry is impaired. We cannot say here, as the Court could in *Addington* v. *Texas*, *id.* at 427, * * * that "the possible injury to the individual is significantly greater than any possible harm to the state."

Because the risk to petitioner that an erroneous finding of fact would lead to his exclusion from the investment advisory business did not outweigh the risk to investors that such an error would permit a faithless fiduciary to continue in his position of trust, the court held that it was appropriate for both parties to bear the risk of error equally through use of the preponderance of the evidence standard (Pet. App. 26).

The court rejected the argument that clear and convincing evidence is required in this context because some of the charges against petitioner rested on violations of antifraud provisions of the federal securities laws. The court noted (Pet. App. 25) that Section 17(a)(2) and

(3) of the Securities Act, 15 U.S.C. 77q(a)(2) and (3), and Section 206(2) of the Investment Advisers Act, 15 U.S.C. 80b-6(2), relied on by the Commission in this case,

> are commonly called "antifraud" provisions, but the offenses they define are fraud in the broadest "remedial" sense of that term and require no showing of intent to injure or injury. See *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 * * * (1963). The facts necessary to establish a violation of these sections—nondisclosure of a material fact—are capable of proof by ordinary direct or circumstantial evidence as in any other administrative proceeding.

The court of appeals expressed concern, however, about the Commission's justification for its selection of severe sanctions in this case. Accordingly, the court remanded the case to the Commission for a further explanation of its rationale for the particular sanctions imposed on petitioner (Pet. App. 27):

> We subscribe to the common-sense notion that the greater the sanction the Commission decides to impose, the greater is its burden of justification. Where, as here, the most potent weapon in the Commission's "arsenal of flexible enforcement powers" * * * is used, the Commission has an obligation to explain why a less drastic remedy would not suffice.

SUMMARY OF ARGUMENT

I.

Selection of the appropriate standard of proof in this case requires a balancing of the individual interest asserted by petitioner and the interest sought to be protected by the Securities and Exchange Commission. When both sides to a controversy have approximately equal interests in avoiding erroneous factual findings, they should "share the risk of error in roughly equal fashion" under the traditional preponderance of the evidence

standard of proof. *Addington* v. *Texas*, 441 U.S. 418, 423 (1979). In this case, petitioner has presented no valid reason why his interest in avoiding an erroneous factual determination outweighs that of the investors whom the Commission seeks to protect. Those investors have entrusted petitioner with hundreds of millions of dollars, and an accurate evaluation of petitioner's fitness to continue in his position of trust is of crucial importance to them. To put petitioner's personal economic interest ahead of that of his investor clients would conflict with elementary concepts of fiduciary duty embodied in the federal securities laws.

The traditional standard of proof in civil litigation is the fair preponderance of the evidence, a standard that governs in proceedings brought under the antifraud provisions of the federal securities laws and even in civil penalty proceedings. That standard assures that decisions in every case rest on the most likely and probable factual inferences. In contrast, petitioner's proposed standard would mean that, in cases in which "clear and convincing evidence" is unavailable, the public would be denied protection even though each and every prerequisite for extending that protection was established by the preponderating weight of the evidence. That result would conflict with the need for accurate administrative adjudications. And considerations of fairness do not require it. Fairness in the present context is guaranteed to petitioner by his right to a trial-type hearing, with numerous procedural safeguards, and subsequent judicial review.

This case bears no resemblance to cases in which this Court has required clear and convincing evidence. Petitioner's economic interest is not similar to that of persons threatened with deportation or indefinite confinement in a mental institution. Indeed, petitioner's interest is substantially less significant than the interest considered in *Vance* v. *Terrazas*, No. 78-1143 (Jan. 15, 1980). That case held that the Due Process Clause does

not require proof by clear and convincing evidence that an individual intended to surrender United States citizenship. *Terrazas* provides *a fortiori* support for the conclusion that the Due Process Clause does not require clear and convincing evidence here.

The fact that clear and convincing evidence has been required in certain common law fraud cases is not relevant to the issues presented in this case. This is a statutory proceeding brought under remedial provisions of the federal securities laws, which is intended to protect investors against future harm by removal of a dishonest trustee. In such a context, common law fraud doctrines are not pertinent. Moreover, the better considered common law decisions recognize that it is inappropriate to create special evidentiary advantages for those accused of fraud to the detriment of those claiming to be their injured victims, and therefore these authorities approve use of the preponderance of the evidence standard in resolving allegations of fraud.

Nor are petitioner's contentions supported by the fact that certain states require clear and convincing evidence before disbarring attorneys. State authorities examine attorneys to evaluate their professional competence, character, and fitness. By judicial order, attorneys are certified to be officers of the court. In contrast, the Commission does not examine investment advisers to determine their competence or character. Accordingly, there is no overriding presumption in favor of their adherence to professional standards. Moreover, the better reasoned state authorities recognize that, even in attorney disbarment proceedings, the public interest requires that the decision of the disciplining body be rendered under the fair preponderance standard, not the clear and convincing standard.

The fact that Commission adjudications may depend on circumstantial or inferential proof is not a ground for requiring clear and convincing evidence. This Court repeatedly has recognized that circumstantial evidence con-

tributes to reliable adjudications. Federal courts and administrative agencies routinely consider circumstantial evidence, along with direct evidence, under the preponderance of the evidence standard.

II.

In the absence of Due Process constraints, a congressional determination that a particular standard of proof is applicable is entitled to judicial deference. See *Vance* v. *Terrazas*, *supra*, slip op. 13-14. In the present context, that standard of proof is the standard contained in the Administrative Procedure Act. Section 7(c) of the Act, 5 U.S.C. 556(d), provides that sanctions may be imposed in administrative proceedings if the evidence is "reliable, probative, and substantial." The legislative history confirms that Congress intended this language to embody the traditional preponderance of the evidence standard. See H.R. Rep. No. 1980, 79th Cong., 2d Sess. 37 (1946): "Where there is evidence pro and con, the agency must weigh it and decide in accordance with the preponderance." In reliance on the APA, the Commission consistently has applied the preponderance of the evidence standard in its adjudicatory proceedings.

III.

Even if the Administrative Procedure Act did not prescribe a standard of proof, the Commission's view that proof by a preponderance is appropriate should be upheld. As this Court noted in *Mathews* v. *Eldridge*, 424 U.S. 319, 349 (1976), "substantial weight must be given to the good-faith judgments of the [persons] charged by Congress with the administration of [the statute] that the procedures they have provided assure fair consideration of the * * * claims of individuals." This Court also confirmed in *Vermont Yankee Nuclear Power Corp.* v. *Natural Resources Defense Council*, 435 U.S. 519, 524 (1978), that the APA prescribes "the maximum procedural requirements which Congress was willing to have

the courts impose upon agencies * * *." Accordingly, "[a]gencies are free to grant additional procedural rights in the exercise of their discretion, but reviewing courts are generally not free to impose them if the agencies have not chosen to grant them."

In view of these principles, this Court should affirm the Commission's reasonable determination that the preponderance of the evidence standard of proof, which requires securities industry fiduciaries to share equally with investors the risk of an erroneous factual finding, is the standard that governs in this administrative proceeding.

ARGUMENT

THE SECURITIES AND EXCHANGE COMMISSION APPROPRIATELY UTILIZED THE PREPONDERANCE OF THE EVIDENCE STANDARD OF PROOF IN THIS ADMINISTRATIVE PROCEEDING

I. A Proper Balancing of the Public and Private Interests in This Case Requires Use of the Preponderance of the Evidence Standard

Following an extensive administrative hearing in which petitioner's right to present evidence and to confront the evidence against him was scrupulously respected, the Commission determined that petitioner had committed numerous violations of, and that sanctions should be imposed under, the federal securities laws, including the Investment Advisers Act and the Investment Company Act. As this Court repeatedly has stated, these statutes were adopted by Congress to establish "federal fiduciary standards" to govern the conduct of investment advisers.[12] Despite the fact that petitioner is a fiduciary

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[12] *Aaron* v. *SEC*, No. 79-66 (June 2, 1980), slip op. 11-12; *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 17 (1979); *Burks* v. *Lasker*, 441 U.S. 471, 481-482 n.10 (1979); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 471 n.11 (1977); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375

and was proceeded against under statutory provisions intended to protect investors against misconduct by their fiduciaries, petitioner claims (Br. 7-15) that the standard of proof in such a proceeding should allocate a much greater risk of error to investors than to himself. There is no support for such a paradoxical contention.

As this Court observed in *Addington* v. *Texas*, 441 U.S. 418, 423 (1979), the standard of proof utilized in a trial-type proceeding "serves to allocate the risk of error between the litigants." Under the traditional preponderance of the evidence standard, the parties bear roughly the same risk of error. A standard of proof more stringent than the traditional preponderance standard protects the favored party against an erroneous decision that is adverse to him, but *increases* the overall likelihood of an erroneous decision. This special measure of protection at the cost of increased error is tolerable only "when the possible injury to the individual is significantly greater than any possible harm to the state." *Id.* at 427. Where, as here, the interests of the fiduciary do not outweigh the interests of the class of investors that the government seeks to protect, there is no valid reason for adopting a standard of proof that would shift the risk of error from the fiduciary and expose his beneficiaries to an increased number of decisional errors.

Unless the premise is accepted that the securities laws are designed to protect those with fiduciary obligations rather than their investor beneficiaries—or, stated otherwise, that it is better that several dishonest trustees remain in their position of trust than that one honest trustee should be mistakenly removed—there is no plausible basis for holding that the Commission must utilize

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U.S. 180, 191-192 (1963). It has likewise been recognized in proceedings under the Securities Act and the Securities Exchange Act that fiduciary obligations rest on broker-dealers. See, *e.g.*, *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017, 1026 (6th Cir. 1979); *Sinclair* v. *SEC*, 444 F.2d 399, 400 (2d Cir. 1971).

a standard of proof more stringent than the preponderance standard. In the present context, a standard of proof that asks the fiduciary "to share equally with society the risk of error" (*Addington* v. *Texas*, *supra*, 441 U.S. at 427) is generous to the fiduciary and cannot be questioned on grounds of accuracy or fairness.

A. *The Traditional Preponderance of the Evidence Standard of Proof is Needed to Minimize Decisional Errors*

Contrary to petitioner's contention (Br. 7, 10, 14-15), use of a "clear and convincing evidence" standard of proof would not contribute to factual accuracy. To the contrary, the preponderance standard of proof is the standard best calculated to arrive at correct factual determinations. Moreover, contrary to the assertion of amicus Securities Industry Association (SIA Br. 8), the overwhelming weight of judicial precedent supports the proposition that the preponderance standard governs here.

With the exception of certain recent decisions of a single court of appeals (see *Collins Securities Corp.* v. *SEC*, 562 F.2d 820 (D.C. Cir. 1977); *Whitney* v. *SEC*, 604 F.2d 676 (D.C. Cir. 1979)), the lower courts consistently have held that administrative adjudications under the federal securities laws do not require a standard of proof greater than the preponderance standard.[13] The lower courts have reached the same result in other ad-

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[13] In addition to the decision of the Fifth Circuit in the present case, see *Investors Research Corp.* v. *SEC*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 97,526 at 97,753 n.41 (D.C. Cir. 1980), petition for cert. pending, No. 80-128; *Abbett, Sommer & Co.* v. *SEC*, [1970-1971] Fed. Sec. L. Rep. (CCH) ¶ 92,813 (D.C. Cir. 1970), cert. denied, 401 U.S. 974 (1971); *DeMammos* v. *SEC*, 23 Ad. L.2d 221 (2d Cir. 1967), aff'g 43 S.E.C. 333, 337 (1967); *Wright* v. *SEC*, 112 F.2d 89, 94 (2d Cir. 1940). See also *Public Service Corp.* v. *SEC*, 129 F.2d 899, 902 (3d Cir.), cert. denied, 317 U.S. 691 (1942); *Pacific Gas & Electric Co.* v. *SEC*, 127 F.2d 378, 382 (9th Cir. 1942).

ministrative contexts, concluding that a preponderance of the evidence is sufficient.[14]

It is likewise well established that issues of fact in civil actions generally are determined in accordance with the preponderance of the evidence.[15] Not only has the traditional civil standard—the preponderance of evidence—been routinely employed by federal courts in civil actions arising under the securities laws,[16] but its use

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[14] See *Martinez* v. *Blum*, No. 80-6002 (2d Cir. June 9, 1980), slip op. 3429 (rejecting the contention that termination of AFDC benefits must be supported by clear and convincing evidence); *Walters* v. *McLucas*, 597 F.2d 1230, 1232 (9th Cir.), cert. denied, 444 U.S. 932 (1979) (approving the preponderance of the evidence standard in an FAA proceeding to revoke a private pilot's license based on violations of aviation regulations and a prior drug conviction); *Alsbury* v. *United States Postal Service*, 530 F.2d 852, 855 (9th Cir.), cert. denied, 429 U.S. 828 (1976) (discharge of postal employee for unlawful removal of government property); *Polcover* v. *Secretary of the Treasury*, 477 F.2d 1223, 1231 (D.C. Cir.), cert. denied, 414 U.S. 1001 (1973) (removal of IRS agent from employment for accepting bribe); *Cargill, Inc.* v. *Hardin*, 452 F.2d 1154, 1169 (8th Cir. 1971), cert. denied, 406 U.S. 932 (1972) (manipulation of price of wheat futures); *Kent* v. *Hardin*, 425 F.2d 1346, 1349 (5th Cir. 1970) (suspension of commodities broker).

[15] See *Addington* v. *Texas*, 441 U.S. 418, 423 (1979); *New York Life Ins. Co.* v. *Gamer*, 303 U.S. 161, 171 (1938); *Fidelity Mutual Life Ass'n* v. *Mettler*, 185 U.S. 308, 317 (1902). It makes no difference that a civil proceeding is "penal" in nature. As this Court held in *United States* v. *Regan*, 232 U.S. 37, 48-50 (1914), in penalty proceedings "the true measure of persuasion is * * * the preponderating weight of the evidence." See also *United States* v. *Ward*, No. 79-394 (June 27, 1980), slip op. 5-6.

[16] See *Mihara* v. *Dean Witter & Co.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 97,508 at 97,662 (9th Cir. 1980); *SEC* v. *Savoy Industries, Inc.*, 587 F.2d 1149, 1168-1169 (D.C. Cir. 1978), cert. denied, 440 U.S. 913 (1979); *SEC* v. *Gilbert*, 79

in Commission actions to enjoin violations of the registration and antifraud provisions of the federal securities laws has been expressly approved by this Court. See *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943). As the Court held in *Joiner*, "[w]here * * * proof is offered in a civil action, as here, a preponderance of the evidence will establish the case * * *."[17]

Very weighty interests—interests at least as substantial as the economic interests asserted by petitioner—are customarily adjudicated in civil proceedings under the preponderance of the evidence standard. No one has ever doubted that in a class action for treble damages brought under the antitrust laws, or in a corporate divestiture proceeding brought under the Federal Trade Commission Act, or a school desegregation case brought under the Fourteenth Amendment, the standard of proof is the preponderance of the evidence. Indeed, the decisions of this Court recognize that the preponderance of the evidence standard governs even in certain phases of criminal proceedings that may be fundamental to the

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F.R.D. 683, 686 (S.D.N.Y. 1978); *University Hill Foundation* v. *Goldman, Sachs & Co.*, 422 F. Supp. 879, 897 (S.D.N.Y. 1976); *Ronson Corp.* v. *Liquifin Aktiengesellschaft*, 370 F. Supp. 597, 602 (D.N.J.), aff'd, 497 F.2d 394 (3d Cir.), cert. denied, 419 U.S. 870 (1974).

[17] The present enforcement case was brought as an administrative proceeding before the Commission. The Commission is also authorized by statute to bring enforcement cases as injunctive actions in federal court, and may determine, in its discretion, the forum or forums in which to proceed. See Section 20(b) of the Securities Act, 15 U.S.C. 77t(b); Section 21(d) of the Securities Exchange Act, 15 U.S.C. 78u(d); Section 42(e) of the Investment Company Act, 15 U.S.C. 80a-41(e); Section 209(e) of the Investment Advisers Act, 15 U.S.C. 80b-9(e). An injunction restrains future unlawful conduct. If it appears that an appropriate sanction in the public interest would be the temporary or indefinite removal of a person from a position of trust in the securities industry, an administrative proceeding is the appropriate vehicle.

outcome of the litigation. For example, the voluntariness of a confession need be shown only by a preponderance of the evidence. See *Lego* v. *Twomey*, 404 U.S. 477 (1972).

The reason for this is plain. The preponderance standard insures that the adjudication rests on the most likely and probable view of the facts.[18] Applying a higher standard, such as the clear and convincing evidence standard, would mean that even though the party seeking a remedy had established that it was more likely than not that each and every prerequisite for the remedy was satisfied, the remedy must be denied if "clear and convincing" evidence was not available. As Professor Davis has recently observed, this is "inconsistent with accuracy." 2 *Administrative Law Treatise* 319 (2d ed. 1979). Such a result should be avoided since "the function of legal process is to minimize the risk of erroneous decisions." *Addington* v. *Texas*, *supra*, 441 U.S. at 425; accord, *Greenholtz* v. *Nebraska Penal Inmates*, 442 U.S. 1, 13 (1979).

In sum, acceptance of petitioner's claim in this case would interject serious inaccuracy in the administrative process. As we demonstrate below, it would also conflict with elementary considerations of fairness.

B. *Use of the Traditional Preponderance of the Evidence Standard is Required by Considerations of Fairness*

At bottom, petitioner's argument is that even though his proposed standard of proof would *increase* the total number of decisional errors, it should be adopted because

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[18] "[W]e want the correct result as often as possible and that means that preponderance of the evidence is only 50% plus. Imposing a greater disadvantage [on one party] would tend to cause more incorrect decisions than correct ones." Winter, *The Jury and the Risk of Nonpersuasion*, 5 Law & Soc. Rev. 335, 337 (1970-1971). See also Ball, *The Moment of Truth: Probability Theory and Standards of Proof*, 14 Vand. L. Rev. 807, 816-817 (1961).

it reduces the likelihood of a particular kind of error—incorrect decisions that are adverse to investment advisers. According to this argument, it is appropriate that investors bear a disproportionate risk of error because investment advisers have a substantial economic stake in continuing their business operations and avoiding sanctions (Br. 5, 15). This line of argument, however, stands the traditional concept of fiduciary duty on its head and runs counter to the basic purpose of the federal securities laws. Moreover, the argument ignores the fact that fairness to investment advisers is assured by the comprehensive procedural safeguards prescribed by Congress and the Commission in cases of this kind.

1. Under the analysis of *Addington* v. *Texas*, *supra*, 441 U.S. at 423-427, selection of the appropriate standard of proof requires a balancing of the individual interest and the interest sought to be protected by the government. The Court noted in *Addington* that "the individual should not be asked to share equally with society the risk of error when the possible injury to the individual is significantly greater than any possible harm to the state" (*id.* at 427). However, when both sides to the controversy have approximately equal interests in avoiding errors, they should "share the risk of error in roughly equal fashion" (*id.* at 423). The Court also noted that "standards of proof are important for their symbolic meaning as well as for their practical effect" (*id.* at 426).

In this case, it is not difficult to identify the correct balance of interests. Petitioner is a fiduciary and the proceeding against him seeks to protect his beneficiaries against continuing deception and flagrant disregard of legal requirements. The fiduciary principle requires that the interests of petitioner's beneficiaries come first. This is the substance of the common law of fiduciary duty [19] and is also basic to the federal securities laws.[20] In short,

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[19] See Scott, *The Fiduciary Principle*, 37 Calif. L. Rev. 539, 540 (1949).

[20] Congress declared in Section 1(b) of the Investment Company Act, 15 U.S.C. 80a-1(b), that the public interest is

considerations of fairness strongly support use of the traditional preponderance of the evidence standard in this context. Indeed, application of that standard to a fiduciary charged with self-dealing is generous. Traditionally in such cases the fiduciary bears the burden of proof (see page 32, *infra*). Imposition of a clear and convincing evidence standard here, which would create special evidentiary protections for investment advisers at the expense of their beneficiaries, would undermine the purpose of the federal securities laws and convey a wholly inappropriate "symbolic meaning" to investors and securities professionals alike. *Addington* v. *Texas*, *supra*, 441 U.S. at 426.[21]

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adversely affected when investment companies "are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, * * * rather than in the interest of all classes of such companies' security holders." Congress there also declared that it is contrary to the public interest to deny investors in investment companies "adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management * * *." Moreover, Congress intended Commission administrative proceedings to be prophylactic proceedings to ensure adherence to high standards of integrity. See *Blaise D'Antoni & Associates, Inc.* v. *SEC*, 289 F.2d 276, 277 (5th Cir.), rehearing denied, 290 F.2d 688, cert. denied, 368 U.S. 899 (1961); *Associated Securities Corp.* v. *SEC*, 283 F.2d 773, 775 (10th Cir. 1960). In this context, "broad discretionary powers in the [Commission] 'have been found practically essential.'" *Superintendent of Insurance* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971). As this Court has emphasized, the "federal fiduciary standards" that govern the conduct of investment advisers were intended by Congress to be "enforceable fiduciary obligations." *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, *supra*, 444 U.S. at 17.

[21] Since the trier of fact here is a government agency rather than a lay jury, there is no need to impose a clear

Turning from legal principle to the respective economic interests in this case, it is also plain that the interests of investment advisers do not outweigh those of public investors. Petitioner undoubtedly has a strong interest in avoiding an erroneous factual determination that could lead to his debarment. But that interest scarcely outweighs the interest of public investors—who at one point entrusted petitioner with $250 million—in obtaining an accurate evaluation of the fitness of their fiduciary to continue in his position of trust. As the court of appeals explained (Pet. App. 26): "The public interest in high standards of conduct in the securities business is a great one." In these circumstances, petitioner can hardly complain that the law requires him to "share the risk of error in roughly equal fashion" (441 U.S. at 423).

As the court of appeals observed, there is a substantial risk that the investing public would be inadequately protected under a clear and convincing evidence standard (Pet. App. 26). Contrary to the sugestion in petitioner's brief that application of the more stringent standard would not significantly impede the enforcement of the securities laws (Br. 8-10), the Commission would not be likely to expend its limited resources in initiating meritorious cases in which it was possible that clear and convincing evidence would not be available. And, in those cases that were brought, the Commission would be forced to withhold sanctions needed to protect investors even though every prerequisite for relief was established by a fair preponderance of the evidence, should that evidence not clearly and convincingly show each required element. In this context, the potential harm to petitioner is not

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and convincing evidence standard to impress upon the agency the importance of the proceeding. In fact, the Commission expressly recognized the serious consequences of the proceeding and the need for procedural fairness: "Though these proceedings are not criminal, they are intensely serious. And we take them very seriously indeed" (Supp. App. 105-106 n.91).

"significantly greater" than the harm to the investing public (*Addington* v. *Texas*, *supra*, 441 U.S. at 427), and the traditional preponderance of the evidence standard accordingly applies. See Comment, *Scope of Review or Standard of Proof—Judicial Control of SEC Sanctions*, 93 Harv. L. Rev. 1845, 1854 (1980).[22]

2. Petitioner's claim that this Court should impose an extraordinary standard of proof to promote fairness is particularly untenable in view of the broad range of procedural safeguards that are afforded to respondents in administrative proceedings before the Commission. In the present case, for example, petitioner had a full hearing, was represented by sophisticated counsel, and exercised his right to cross-examine and confront opposing witnesses. He received the benefit of the imposition on the Commission's staff of the burden of proving that he willfully violated the federal securities laws. He had the right to testify in his own behalf—which he chose not to exercise—and to present other evidence in his defense. He appealed his case to the Commission and received an independent review of the factual record. He also utilized his right to brief the legal and factual issues in the case and

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[22] Vigorous government enforcement of the federal securities laws to protect the clients of investment advisers is particularly important in view of the limited availability of private remedies. See, *e.g.*, *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, *supra*. The economic consequences of lax enforcement in this area can scarcely be overstated. According to estimates prepared in connection with the Commission's budget submission to Congress for the fiscal year ending September 30, 1982, assets currently under advisement by registered investment advisers total approximately $600 billion. Evidentiary rules that would prevent the Commission from disciplining dishonest fiduciaries in this industry would subvert the congressional purpose to " 'achieve a high standard of business ethics * * * in every facet of the securities industry.' " *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-187 (1963).

present oral argument. Following the Commission's decision, he obtained judicial review that afforded him a renewed opportunity to contest the substantiality of the evidence, the propriety of the Commission's procedures, the correctness of the Commission's interpretation of the federal securities laws, and the sufficiency of the Commission's justification for the sanctions imposed.

This extended hearing procedure guaranteed the accuracy and fairness of the ultimate result. As Justice Frankfurter observed in his concurring opinion in *Joint Anti-Fascist Refugee Committee* v. *McGrath*, 341 U.S 123, 171-172 (1951): "No better instrument has been devised for arriving at truth than to give a person in jeopardy of serious loss notice of the case against him and opportunity to meet it." While the decisions of this Court confirm that "some form of hearing is required before an individual is finally deprived of a property interest" (*Mathews* v. *Eldridge*, 424 U.S. 319, 333 (1976)), the procedural requirements in such a hearing are "flexible" (*id.* at 334). This Court has recognized that "[a]t some point the benefit of an additional safeguard to the individual affected by the administrative action * * * may be outweighed by the cost" (*id.* at 348). "All that is necessary is that the procedures be tailored, in light of the decision to be made, to 'the capacities and circumstances of those who are to be heard,' * * * to insure that they are given a meaningful opportunity to present their case" (*id.* at 349). See *Arnett* v. *Kennedy*, 416 U.S. 134, 155 (1974) (dismissal of federal employee); *Goldsmith* v. *United States Board of Tax Appeals*, 270 U.S. 117, 123 (1926) (denial of admission to practice and disbarment of accountants). See also *Greenholtz* v. *Nebraska Penal Inmates*, *supra*, 442 U.S. at 12-13, noting that due process "is flexible and calls for such procedural protections as the particular situation demands."

In sum, petitioner had the opportunity to assure that the determination in this case was not based on a mistaken understanding of the facts. The extensive pro-

cedural protections granted to him resulted in a disposition that was both fair and accurate. His claim that, in addition to these procedural safeguards, he was entitled to a standard of proof that would distort the accuracy of the fact-finding process is an extravagant assertion that finds no support in the requirements of the Due Process Clause or the federal securities laws.[23]

C. *This Proceeding Does Not Involve a Constitutional Right or Extraordinary Interest That Would Dictate Use of a Higher Standard of Proof*

As previously noted, this Court's decisions recognize that the fair preponderance of the evidence standard governs in most civil cases, including civil cases involving allegations of fraud under the federal securities laws and

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[23] Under the Securities Exchange Act, national securities exchanges and national securities associations, in addition to the Commission, are authorized to conduct proceedings to resolve charges that securities industry personnel have violated the securities laws, including the antifraud provisions, and to impose sanctions, including suspension or debarment from positions in the industry. The legislative history of the 1975 Amendments to the Securities Exchange Act, Pub. L. No. 94-29, 89 Stat. 97, demonstrates that Congress deliberately prescribed for these disciplinary hearings only those procedures basic to "fundamental standards of due process." S. Rep. No. 94-75, 94th Cong., 1st Sess. 29 (1975). A requirement that self-regulatory bodies conducting disciplinary proceedings apply a standard of proof more stringent than the traditional preponderance of the evidence was not one of the requirements that Congress deemed necessary to satisfy due process. Rather, self-regulatory organizations are required to lodge specific written charges; give notice of those charges; provide an opportunity to defend; compile a record; and specify in any adverse determination the acts that constitute the violation, the statutory provision violated, the sanction imposed, and the reasons therefor. See Sections 6(d)(1) and 15A(h)(1) of the Securities Exchange Act, 15 U.S.C. 78f(d)(1) and 78o-3(h)(1). See also 2 K. Davis, *Administrative Law Treatise* 325-328, 499-504, 509-512 (2d ed. 1979).

even civil cases seeking to impose substantial penalties on those who violate the law. See pages 17-19, *supra;* see also *McCormick on Evidence* § 399 (2d ed. 1972). Those exceptional situations in which a higher standard has been employed differ fundamentally from the present case and highlight the inappropriateness of using a clear and convincing evidence standard here. For example, the First Amendment rights of newspapers demand proof by clear and convincing evidence before a publisher may be found liable for reckless or knowing defamation. *New York Times Co.* v. *Sullivan*, 376 U.S. 254, 280, 285-286 (1964). Plainly, the public interest in removing faithless trustees far exceeds the public interest in providing private compensation in libel cases. Similarly, clear and convincing evidence is required before an individual is stripped of personal freedom and confined indefinitely in a mental institution (*Addington* v. *Texas*, *supra*), and before an individual can be forced to endure the "drastic deprivations" of deportation (*Woodby* v. *INS*, 385 U.S. 276, 285 (1966)). The effect on petitioner of indefinite debarment from a segment of the securities industry cannot be compared to the drastic deprivations in those cases. Nor can the compelling societal interest in obtaining a correct evaluation of the honesty of a trustee managing hundreds of millions of dollars of other people's money be compared to the societal interest in expelling an individual alien or committing a citizen to a mental institution.

This Court's latest pronouncement on the clear and convincing evidence standard demonstrates that there is no merit to petitioner's claim that the severity of the sanction against him requires such a standard of proof. In *Vance* v. *Terrazas*, No. 78-1143 (Jan. 15, 1980), slip op. 13-14, this Court held that the Due Process Clause does not require the clear and convincing evidence standard even when the proceeding has a potential result as

harsh as expatriation. The Court explained in *Terrazas* that, while "in criminal and involuntary commitment contexts we have held that the Due Process Clause imposes requirements of proof beyond a preponderance of the evidence," expatriation proceedings "are civil in nature and do not threaten a loss of liberty." *A fortiori*, the interest of petitioner in maintaining his position in the securities industry is not so compelling as to require an extraordinary standard of proof. Petitioner's assertion that his right to pursue his "chosen occupation" is at risk (Br. 8) is far less weighty than Terrazas' assertion that his right to remain a United States citizen was at risk.

The Commission's order in this case bars petitioner from future association with investment advisers and investment companies. He has profitably engaged in that occupation in the past but repeatedly has failed to maintain the standards of honesty that are the preconditions for retaining his position of trust. See generally *Arnett* v. *Kennedy*, *supra*, 416 U.S. at 151-157. The sanction imposed in this case can be modified by the Commission if petitioner establishes that it is no longer needed to protect the public interest (see note 37, *infra*).

Imposition by this Court of an extraordinary standard of proof in the present case would have a fundamentally unsettling effect on civil litigation in general and administrative proceedings in particular. In most important cases, arguments can be made that the proceeding involves a potential "stigma" (for example, a case of deceptive advertising under the Federal Trade Commission Act), that the proceeding threatens loss of the right to pursue one's "chosen occupation" (for example, the discharge of a federal employee based on dishonest acts or the revocation of a pilot's license based on reckless conduct), or that the proceeding involves significant "financial losses" (for example, a civil divestiture suit brought by the Department of Justice). These considerations do not, however, give rise to the special concern

for personal liberty or protection of fundamental rights that has led the Court to require clear and convincing evidence in past cases. Indeed, even where "civil suits involve the proof of acts which expose the party to a criminal prosecution * * * proof by a reasonable preponderance of the evidence is sufficient." *United States* v. *Regan*, 232 U.S. 37, 49 (1914), cited with approval in *United States* v. *Ward*, No. 79-394 (June 27, 1980), slip op. 5-6.

D. *A Higher Standard of Proof is not Required Simply Because This Proceeding Involves Charges of Violations of the Antifraud Provisions of the Federal Securities Laws*

Petitioner also argues (Br. 15, 24) that clear and convincing evidence is required because he was charged with violating antifraud provisions of the federal securities laws. That argument is meritless for reasons that already have been mentioned. This Court has held that a "preponderance of the evidence" suffices in a civil proceeding alleging antifraud violations. See *SEC* v. *C.M. Joiner Leasing Corp.*, *supra*, 320 U.S. at 355. There is, moreover, a still more fundamental defect in petitioner's argument. This proceeding presents no analogy to a common law fraud action. This is a statutory proceeding designed to protect investors against future harm. Finally, even if common law fraud cases were relevant here, the better considered decisions in that context recognize that the preponderance of the evidence standard governs.

1. The antifraud provisions of the federal securities laws are not coextensive with common law doctrines of fraud and deceit. See generally *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 744-745 (1975). Congress enacted the federal securities laws to remedy inadequacies in the common law. "A fundamental purpose, common to [the federal securities] statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *SEC* v. *Cap-*

ital Gains Research Bureau, Inc., supra, 375 U.S. at 186. Far from limiting its protections to those provided at common law, the Investment Advisers Act reflects " 'a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.' " *Aaron* v. *SEC,* No. 79-66 (June 2, 1980), slip op. 11-12, quoting *SEC* v. *Capital Gains Research Bureau, Inc., supra,* 375 U.S. at 191-192.

In *Capital Gains,* an injunctive action brought by the Commission against an investment adviser who had committed antifraud violations, the defendants argued that the Commission must prove the violations by clear and convincing evidence. A panel of the court of appeals accepted that argument. *SEC* v. *Capital Gains Research Bureau, Inc.,* 300 F.2d 745, 747 (2d Cir. 1961). While this Court did not address that specific issue when it reversed the decision of the court of appeals, it rejected the entire premise on which the argument was based—*i.e.,* that the antifraud provisions of the federal securities laws, particularly those in the Investment Advisers Act, are circumscribed by rigid common law fraud doctrines. The Court explained (375 U.S. at 194-195) (emphasis supplied):

> Courts have imposed on a fiduciary an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts," as well as an affirmative obligation "to employ reasonable care to avoid misleading" his clients. * * *
>
> We cannot assume that Congress, in enacting legislation to prevent fraudulent practices by investment advisers, was unaware of these developments in the common law of fraud. Thus, even if we were to agree with the courts below that Congress had intended, in effect, to codify the common law of fraud in the Investment Advisers Act of 1940, *it would be logical to conclude that Congress codified the common law "remedially" as the courts had adapted it*

> *to the prevention of fraudulent securities transactions by fiduciaries, not "technically" as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels.*[24]

In an earlier case, the D.C. Circuit correctly rejected the argument that common law doctrines of fraud apply in administrative proceedings instituted by the Commission to revoke the registration of broker-dealers who violate the antifraud provisions of the federal securities laws. To accept such an argument, the court noted, "would be to adopt the fallacious theory that Congress enacted existing securities legislation for the protection of the broker-dealer rather than for the protection of the public." *Norris & Hirshberg, Inc.* v. *SEC*, 177 F.2d 228, 233 (D.C. Cir. 1949).

These considerations apply here and require rejection of petitioner's argument that clear and convincing evidence must be presented in an administrative proceeding of this kind.

2. Petitioner's reliance on common law fraud decisions is also unavailing because the better considered common law authorities approve the preponderance of the evidence standard rather than the clear and convincing evidence standard. As this Court observed in *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 194:

> There has also been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as [investment] advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue.

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[24] Accord, *Hughes* v. *SEC*, 174 F.2d 969 (D.C. Cir. 1949); *Charles Hughes & Co.* v. *SEC*, 139 F.2d 434 (2d Cir.), cert. denied, 321 U.S. 786 (1943); see 3 L. Loss, *Securities Regulation* 1435 (2d ed. 1961).

Thus, some state courts have declined to apply a more stringent standard of proof in cases involving allegations of fraud when securities were involved or when violations of state blue sky laws were at issue.[25] Moreover, it is generally recognized that a high standard of proof is not appropriate in cases involving claims of breach of fiduciary duty. Once a fiduciary relationship and self-dealing by the fiduciary have been shown, the burden shifts to the fiduciary to prove that the transaction was lawful and that he has not abused the relationship.[26]

Furthermore, even outside the area of securities fraud and fraud by fiduciaries, "[t]he policy of placing such a special burden [the clear and convincing evidence requirement] on one who claims to be the victim of fraud is debatable." *McCormick on Evidence, supra,* § 340, at 797 n.74. The better reasoned state court decisions hold that there is no sound reason for according special evidentiary

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[25] See, *e.g., S&F Supply Co.* v. *Hunter,* 527 P.2d 217, 220-221 (Utah 1974) (to obtain redress under state antifraud provisions plaintiff must show elements of the violation by a preponderance of the evidence). See also 11C (Part 2) H. Sowards & N. Hirsch, *Business Organizations, Blue Sky Regulation* § 6.01, at 6-4 to 6-5 (1979) (footnote omitted):

> The nature of the blue sky laws virtually demands that they be liberally interpreted in order to effectuate the antifraud purposes. This * * * has altered the principle governing the weight of evidence in civil cases. * * * [F]raud actions brought under the blue sky laws have been decided in some states according to a fair preponderance of the evidence, which has been described as a probability of belief by triers of fact.

[26] *Garrett* v. *Moore-McCormick Co.,* 317 U.S. 239, 247 (1942); *Geddes* v. *Anaconda Copper Mining Co.,* 254 U.S. 590, 599 (1921); *Francois* v. *Francois,* 599 F.2d 1286, 1290-1293 (3d Cir. 1979), cert. denied, No. 79-5548 (Jan. 7, 1980); *Nedd* v. *UMW,* 556 F.2d 190, 210 (3d Cir. 1977), cert. denied, 434 U.S. 1013 (1978); *Ohio Drill & Tool Co.* v. *Johnson,* 498 F.2d 186, 195 (6th Cir. 1974).

benefits to those accused of fraud at the expense of those claiming to be their injured victims, and they have explicitly adhered to the preponderance of the evidence standard of proof when fraud is at issue.[27] Likewise, a substantial number of authorities, including those available at the time when the federal securities laws were enacted, acknowledge that the preponderance of the evidence standard applies in most civil actions involving allegations of fraud.[28] As one commentator explained:

> Parties engaged in fraudulent schemes always resort to the use of legal forms, as far as possible, to cover their purposes; and hence it would often be expecting

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[27] ARKANSAS: *Ray Dodge, Inc.* v. *Moore*, 251 Ark. 1036, 1041, 479 S.W.2d 518, 521-522 (1972); CALIFORNIA: *Liodas* v. *Sahadi*, 562 P.2d 316, 321-323, 137 Cal. Rptr. 635, 639-643 (1977); COLORADO: *Goodfellow* v. *Kattnig*, 533 P.2d 58, 60 (Colo. App. 1975); FLORIDA: *Rigot* v. *Bucci*, 245 So.2d 51, 53 (1971); *Blaeser Development Corp.* v. *First Federal Savings & Loan Ass'n*, 375 So.2d 1118 (Fla. App. 1979); INDIANA: *Grissom* v. *Moran*, 154 Ind. App. 419, 427, 290 N.E.2d 119, 123 (1972); MONTANA: *Cowan* v. *Westland Realty Co.*, 162 Mont. 379, 383, 512 P.2d 714, 716 (1973); NEW JERSEY: *Medivox Productions, Inc.* v. *Hoffmann-LaRoche, Inc.*, 107 N.J. Super. 47, 69, 256 A.2d 803, 814-815 (1969); OHIO: *Household Finance Corp.* v. *Altenberg*, 5 Ohio St.2d 190, 214 N.E.2d 667 (1966); RHODE ISLAND: *Smith* v. *Rhode Island Co.*, 39 R.I. 146, 153-154, 98 A. 1, 4 (1916); SOUTH DAKOTA: *General Electric Credit Corp.* v. *M.D. Aircraft Sales, Inc.*, 266 N.W.2d 548, 550 (1978); VERMONT: *In re Delligan's Estate*, 111 Vt. 227, 234-235, 13 A.2d 282, 287 (1940). See also *Jensen* v. *Sohler*, 601 F.2d 353, 354-355 (8th Cir. 1979).

[28] See, *e.g.*, 20 Am. Jur., *Evidence* §§ 1248, 1255 (1939); 24 Am. Jur., *Fraud and Deceit* §§ 278, 279 (1939); Annot., 62 A.L.R. 1449 (1929) (majority rule requires a preponderance of the evidence to establish fraudulent, dishonest or criminal misappropriation of property); Annot., 33 L.R.A. (N.S.) 836 (1911). See also 2 T. Cooley, *Treatise on the Law of Torts* § 349, at 552-554 (4th ed. 1932).

> too much to look for clear and undisputed evidence of fraud. The law therefore does not require it * * *. *It is settled law that, upon the trial of a civil action in which the claim or defence is based on alleged fraud, the issue may be determined in accordance with the preponderance or weight of evidence,* except in cases of resulting trusts arising on verbal agreements to buy for another.

M. Bigelow, *The Law of Fraud and the Procedure Pertaining to the Redress Thereof* 474 (1877) (footnotes omitted, emphasis supplied).

3. While decisions in non-statutory fraud cases involving private parties have sometimes employed a clear and convincing evidence standard, particularly when certain types of equitable relief have been sought,[29] the use of the higher standard generally has rested on historical considerations that have no pertinence here. The practice of requiring a more stringent standard of proof appears to have arisen in actions in which the chancellor was requested to grant relief on claims that were unenforceable at law for failure to comply with the Statute of Frauds or the Statute of Wills, and was subsequently applied in actions seeking to set aside or alter the terms of written instruments. A higher standard of proof was employed in such cases because they were believed to involve special dangers that claims might be fabricated. See Note, *Appellate Review in the Federal Courts of Findings Requiring More than a Preponderance of the Evidence,* 60 Harv. L. Rev. 111, 112 (1946). The concern of the courts in these circumstances was the need to protect the sanctity of written instruments and the reliance placed upon such documents. See *Rice-Stix Dry Goods Co.* v. *Montgomery,* 164 Ark. 161, 171, 261 S.W. 325, 329 (1924), quoted in *McCormick on Evidence, supra,* § 340, at 797 n.74 (emphasis supplied):

> [I]n actions at law one who has the burden of proof to establish fraud meets the requirements of the rule

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[29] See 9 J. Wigmore, *Evidence* § 2498 (3d ed. 1940).

> when he proves the fraud only by a preponderance of the evidence. The same rule likewise prevails in equity, *except in those cases where the rescission, cancellation, or reformation of a writing for fraud of one party and mistake of the other, or mutual mistake, is the relief sought,* in which latter case, as we have stated, the proof of fraud or mistake must be clear, unequivocal, and decisive.[30]

Early decisions of this Court express similar concerns in determining the standard of proof needed for overturning land patents granted by the United States.[31]

The concerns expressed in these cases have no relevance here. Regulation under the securities laws of the conduct of investment advisers poses no danger to the sanctity of written documents or official acts. More fundamentally, imposition of a standard of proof borrowed from inapposite common law cases would undermine the important purposes of the federal securities laws, which Congress enacted to remedy inadequacies in common law protections. It is inconceivable that Congress would have intended to distort the fact-finding process under these statutes so that fiduciaries charged with fraud could retain their position of trust even though the preponder-

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[30] Accord, *Ray Dodge, Inc.* v. *Moore,* 251 Ark. 1036, 1041, 479 S.W.2d 518, 521 (1972) ("Clear and convincing evidence of fraud is required to cancel or reform a solemn writing, but not to establish fraud in obtaining a contract by fraudulent misrepresentation."); *Household Finance Corp.* v. *Altenberg,* 5 Ohio St.2d 190, 214 N.E.2d 667 (1966); *In re Delligan's Estate,* 111 Vt. 227, 234-235, 13 A.2d 282, 287 (1940). This same rationale, *i.e.,* the protection of written documents, is apparent in most of the instances in which Wigmore states that " 'clear and convincing proof' is commonly applied." 9 J. Wigmore, *Evidence* § 2498 (3d ed. 1940); see Note, *supra,* 60 Harv. L. Rev. at 112.

[31] See, *e.g., United States* v. *Budd,* 144 U.S. 154, 161-162 (1892); *Maxwell Land-Grant Case,* 121 U.S. 325, 382 (1887). See also *United States* v. *American Bell Telephone Co.,* 167 U.S. 224, 240-241 (1897) (patent on invention granted by the United States).

ating weight of the evidence showed that every prerequisite supporting their removal had been established.[32]

E. *A Higher Standard of Proof is not Required by the Fact That This is a Disciplinary Proceeding*

Petitioner also argues that he has a "right" to pursue his "chosen occupation" (Br. 8), and, like an attorney subject to disbarment, cannot be deprived of that right without proof of misconduct by clear and convincing evidence (Br. 24).

However, disciplinary proceedings brought by the Commission against investment advisers and other securities industry fiduciaries bear little resemblance to disciplinary proceedings against lawyers brought by state bar authorities. Commission disciplinary proceedings are an important factor in the regulation of the public securities markets. Investment advisers, unlike lawyers, may enter into this sensitive industry without graduate education, without examination by governmental authorities to establish their knowledge in the field, and without examination by any committee on fitness and character. In contrast to the legal profession, "anyone can become registered to give [investment] advice to others, regardless of whether that person has any prior education, training, or experience in financial matters, and regardless of whether he is financially able to perform the services contracted for." [33] Thus, "[u]nder the law

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[32] Congress' views on the need to avoid standards of proof that frustrate investor protection can be discerned from Sections 11(b) and 12(2) of the Securities Act, 15 U.S.C. 77k(b), 77*l*(2). Under those antifraud provisions, persons charged by investors with misrepresentation must bear the burden of proof to establish their lack of culpability.

[33] S. Rep. No. 94-910, 94th Cong., 2d Sess. 2 (1976). The only steps a person need take to register as an investment adviser are to file an application and pay a filing fee. See 15 U.S.C. 80b-3(c)(1); 17 C.F.R. 275.203-3.

as it exists today, any person of any qualification or lack thereof can become a portfolio manager of vast sums of money." [34] This stands in sharp contrast to the case of the attorney who, "upon admission to the bar, [is] certified by the court to have then attained high moral and professional standards." *In re Little*, 40 Wash.2d 421, 430, 244 P.2d 255, 259-260 (1952). In light of this judicial certification, the court in *Little* stated that "[i]t is to be presumed that he has maintained [those standards] and has performed his duty as an officer of the court in accordance with his oath." *Ibid.*

In short, the ease of entry into the investment advisory field, which differs fundamentally from the legal profession, highlights the importance of enforcing federal fiduciary standards through administrative proceedings utilizing the standard of proof most consistent with an accurate evaluation of the evidence. This conclusion is reinforced by the fact that many jurisdictions recognize that the public interest requires use of the preponderance of the evidence standard in attorney disbarment proceedings.[35]

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[34] *Hearings on S. 2849 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs*, 94th Cong., 2d Sess. 76 (1976).

[35] ALABAMA: *Dodd* v. *Board of Commissioners*, 350 So.2d 700, 705 (1977); ALASKA: *In re Robson*, 575 P.2d 771, 776-777 (1978); ARKANSAS: *Hurst* v. *Bar Rules Committee*, 202 Ark. 1101, 1110, 155 S.W.2d 697, 701 (1941); HAWAII: *In re Trask*, 46 Hawaii 404, 410-411, 380 P.2d 751, 755 (1963); INDIANA: *In re Pawlowski*, 240 Ind. 412, 432-433, 165 N.E. 2d 595, 605 (1960); KENTUCKY: *Louisville Bar Ass'n* v. *Hubbard*, 282 Ky. 734, 742, 139 S.W.2d 773, 777 (1940); MASSACHUSETTS: *In re Mayberry*, 295 Mass. 155, 166-167, 3 N.E.2d 248, 253 (1936); MICHIGAN: *State Administrator* v. *Posler*, 390 Mich. 581, 213 N.W.2d 133 (1973); MISSOURI: *In re Duncan*, 541 S.W.2d 564, 568-569 (1976); NEW YORK: *Feola* v. *New York State Bar Ass'n*, 37 App. Div.2d 789, 324 N.Y.S.2d 654 (1971); OHIO: *Cleveland Bar*

Finally, although petitioner claims that he has a "right" to serve as an investment adviser, Congress has declared that he enjoys no life tenure. Like other trustees, he can be removed for dishonesty.[36] And the order of removal is properly continued until he establishes that his reinstatement is consistent with the public interest.[37]

F. *A Higher Standard of Proof is not Required Merely Because Circumstantial Evidence is Relied Upon*

Petitioner also argues (Br. 16-19) that reliance on inferential or circumstantial evidence to prove mental state in a proceeding of this kind makes the traditional preponderance of the evidence standard inappropriate.

Petitioner overstates the importance of circumstantial evidence in cases of this kind. Petitioner's violations, as evidenced by the repeated transfer of accounts from bank to bank, the loans, the nondisclosures, the failure to file timely reports, and the other conduct found by the Commission to have occurred in this case, were established by direct evidence. No inferential reasoning was required to prove this conduct.[38]

Ass'n v. *Fleck*, 172 Ohio St. 467, 469, 178 N.E.2d 782, 784 (1961), cert. denied, 369 U.S. 861 (1962); TEXAS: *Houtchens* v. *State*, 63 S.W.2d 1011, 1015 (Tex. App. 1933). See also Annot., 105 A.L.R. 984, 985 (1936).

[36] See II A. Scott, *Trusts* § 107, at 840-844 (1967) (a trustee "will be removed if his conduct is such as to show his unfitness to administer the trust"). See also III A. Scott, *Trusts* § 187.1, at 1509 (1967).

[37] See Pet. App. 28 n.17; Supp. App. 119 n.100; see also *Hanly* v. *SEC*, 415 F.2d 589, 598 (2d Cir. 1969); *Lawrence* v. *SEC*, 398 F.2d 276, 281 (1st Cir. 1968); Securities Exchange Act Release No. 11267, 6 S.E.C. Docket 346 (Feb. 26, 1975) ("application for relief from disqualification"); *In re Brick*, 8 S.E.C. Docket 240, 247-248 n.38 (1975).

[38] Where, as here, findings of violations are made under the antifraud provisions of Section 17(a) (2) and (3) of the Secu-

Moreover, partial reliance on circumstantial or inferential evidence does not require a higher standard of proof, since, as this Court has recognized, "[c]ircumstantial evidence is not only sufficient, but may also be more certain, satisfying and persuasive than direct evidence." *Michalic* v. *Cleveland Tankers, Inc.*, 364 U.S. 325, 330 (1960).[39] Indeed, this Court recognized the value of such proof in *SEC* v. *C. M. Joiner Leasing Corp.*, *supra*, 320 U.S. at 355, when it held that economic inducements surrounding the sale of leaseholds were circumstantially relevant in determining whether those instruments were securities. See also *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 463 & n.24 (1976) (fraudulent market manipulation may be proven "by circumstantial as well as direct evidence").

Of course, in cases of this kind the Commission must find, in addition to the elements of the underlying violation, that the conduct was "willful." But, contrary to petitioner's suggestion (Br. 17-19), the meaning of the willfulness requirement is not at issue here. The essential point is that willfulness, like any other relevant fact in an administrative proceeding, is subject to reli-

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rities Act and Section 206(2) of the Investment Advisers Act, proof of scienter is not required to establish the violations. *Aaron* v. *SEC*, *supra*; *Capital Gains Research Bureau, Inc.* v. *SEC*, *supra*. Thus, the primary element to be proven in the proceeding—the underlying violation of the securities laws—does not require proof of mental state.

[39] See also *Rogers* v. *Missouri Pacific R.R.*, 352 U.S. 500, 508 n.17 (1957); *Holland* v. *United States*, 348 U.S. 121, 139-140 (1954); *Rea* v. *Missouri*, 84 U.S. (17 Wall.) 532, 543 (1873); *Lukon* v. *Pennsylvania R.R.*, 131 F.2d 327, 329 (3d Cir. 1942) (circumstantial evidence "has probative value equal to that of testimonial evidence").

able proof under a preponderance standard. Indeed, a party concerned about the accuracy of the agency's determination as to willfulness is free to present evidence, including his own direct testimony, concerning that matter. Petitioner had the opportunity to provide such direct evidence, but declined to do so (Supp. App. 51). A party having direct evidence in his sole possession—but who refuses to divulge it—cannot complain of the agency's reliance on probative inferential evidence. See generally *Baxter* v. *Palmigiano*, 425 U.S. 308, 318-319 (1976); *Local 167, Int'l Brotherhood of Teamsters* v. *United States*, 291 U.S. 293, 298 (1934); *Proud* v. *CAB*, 357 F.2d 221, 223-224 (7th Cir. 1966).

In short, there is nothing unusual or improper about relying on circumstantial evidence to prove state of mind in a civil proceeding. This is a commonplace inquiry in federal courts and federal administrative agencies, and the task is traditionally performed pursuant to the preponderance of the evidence standard of proof.[40]

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[40] In *Vance* v. *Terrazas, supra,* slip op. 14, this Court approved the preponderance of the evidence standard in a case requiring proof of specific intent to relinquish citizenship. The Court noted that the government's duty to prove the state of mind element was "in itself a heavy burden" that militates *in favor* of using the preponderance standard of proof.

If petitioner were correct in asserting (a) that inferential and circumstantial evidence is inherently speculative and unreliable, and (b) that the government must present clear and convincing evidence of state of mind (Br. 19), then it would logically follow that the government could rarely (if ever) obtain an order to protect the public. If the respondent investment adviser—like petitioner—refused to provide "direct" testimony concerning his state of mind, then the only evidence in the case would be circumstantial evidence,

II. The Administrative Procedure Act Contemplates Use of the Preponderance of the Evidence Standard in Administrative Proceedings of This Kind

This Court recognized in *Vance* v. *Terrazas, supra,* that when Congress specifies a standard of proof, that legislative judgment ordinarily controls. The Court emphasized the "traditional powers of Congress to prescribe rules of evidence and standards of proof" (slip op. 13) and noted that "a congressional judgment * * * that the preponderance standard of proof provides sufficient protection" is entitled to deference (*id.* at 14).

While Congress has mandated a more stringent evidentiary standard than preponderance of the evidence in certain federal statutes,[41] it has not done so in the federal securities laws. Adjudicatory proceedings under those laws, however, are governed by Section 7(c) of the Administrative Procedure Act ("APA"), 5 U.S.C. 556(d).[42] Section 7(c) provides in pertinent part (emphasis supplied):

> Except as otherwise provided by statute, the proponent of a rule or order has the burden of proof. * * * *A sanction may not be imposed or rule or order issued except* on consideration of the whole record or those parts thereof cited by a party and supported by and *in accordance with the reliable, probative, and substantial evidence.*[43]

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which, by petitioner's hypothesis, would be speculative and unreliable and insufficient under the clear and convincing standard of proof.

[41] See, *e.g.*, 8 U.S.C. 1448(a); 19 U.S.C. (Supp. II) 1592(e)(2); 25 U.S.C. (Supp. II) 1912(e); 38 U.S.C. 354(b).

[42] See Sections 5 and 7 of the APA, 5 U.S.C. 554(a) and 556(a); Sections 15(b)(4) and 15(b)(6) of the Securities Exchange Act, 15 U.S.C. 78*o*(b)(4) and 78*o*(b)(6); Sections 203(e) and 203(f) of the Investment Advisers Act, 15 U.S.C. 80b-3(e) and 80b-3(f); Section 9(b) of the Investment Company Act, 15 U.S.C. 80a-9(b).

[43] Section 7(c) is directed to two distinct questions—the type of evidence to be received (evidence that is separately

Nothing on the face of this statute suggests that Congress intended to apply the extraordinary "clear and convincing evidence" standard of proof. To the contrary, the words "reliable," "probative," and "substantial" show that Congress meant to endorse the traditional preponderance standard—the standard that produces adjudications in every case that are consistent with the most probable and likely factual inferences. In discussing Section 7(c), the House Report that accompanied the APA explained (H.R. Rep. No. 1980, 79th Cong., 2d Sess. 37 (1946) (emphasis supplied)):

> [W]here a party having the burden of proceeding has come forward with a prima facie and substantial case, he will prevail unless his evidence is discredited or rebutted. In any case the agency must decide "in accordance with the evidence." *Where there is evidence pro and con, the agency must weigh it and decide in accordance with the preponderance.*

See also the dissenting opinion of Justices Clark and Harlan in *Woodby* v. *INS*, *supra*, 385 U.S. at 288-289 n.1, which explains that the APA standard of "reliable, probative, and substantial" evidence has "traditionally been held satisfied when the agency decides on the preponderance of the evidence." The majority in *Woodby* did not disagree with that analysis.[44] Moreover, the same

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described in Section 7(c) as not "irrelevant, immaterial, or unduly repetitious") and the standard of proof that must be satisfied to support a sanction ("reliable, probative, and substantial evidence"). See H.R. Rep. No. 1980, 79th Cong., 2d Sess. 53 n.16 (1946).

[44] The majority in *Woodby* required a higher standard of proof in the deportation proceeding before the Court. However, that proceeding was not governed by the APA (see 385 U.S. at 287-288 (Clark, J., dissenting)). The majority concluded in *Woodby* that the Immigration and Nationality Act did not prescribe a standard of proof; instead, the Act prescribed a standard of judicial review. In these circumstances,

court that decided *Collins* and *Whitney* has also recognized that the APA prescribes the preponderance of the evidence standard.[45]

Enactment of the APA confirmed the use of the preponderance of the evidence standard that the Commission had applied in earlier cases.[46] Following the passage

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the Court held that it was appropriate for the judiciary to devise an appropriate standard of proof (385 U.S. at 284).

Unlike the Immigration Act, the APA has always contained a separate judicial review section designated as such. See Section 10(e), 5 U.S.C. 706. That provision is worded differently from Section 7(c). Both the language of Section 7(c) and its legislative history (see pages 41-42, *supra*) confirm that it prescribes a standard of proof.

[45] In *Sea Island Broadcasting Co.* v. *FCC*, 47 Ad. L.2d 831 (1980), the D.C. Circuit noted that "the 'preponderance of evidence' standard is the traditional standard in civil and administrative proceedings." The Court added: "It is the one contemplated by the APA, 5 U.S.C. 556(d)." *Id.* at 835 & n.6, citing H.R. Rep. No. 1980, 79th Cong., 2d Sess. 37 (1946). Although the court recognized that the administrative proceeding under review (a broadcast license revocation proceeding) was governed by the APA, it nevertheless concluded that the agency must apply the clear and convincing evidence standard. The court stated that, in its view, the proceeding was comparable to a broker-dealer disciplinary proceeding and therefore was governed by its earlier decisions in *Collins* and *Whitney*. In so ruling, the court made no attempt to justify its conclusion that the FCC must deviate from the statutory standard prescribed in the APA. 47 Ad. L.2d at 835-837.

[46] As early as 1938, the Commission had rejected the argument that in a proceeding to determine whether to suspend, expel or otherwise sanction a brokerage firm and its principals for, *inter alia*, manipulation of security prices in violation of Section 9 of the Securities Exchange Act, 15 U.S.C. 78i, a standard of proof greater than the preponderance of the evidence standard is required. *In re White*, 3 S.E.C. 466, 539, 540 (1938).

of the APA, the Commission considered the question anew in a proceeding leading to the revocation of the registration of a broker-dealer. *In re Pollisky*, 43 S.E.C. 458 (1967). In determining that a more stringent standard such as that applicable in deportation cases was inappropriate, the Commission relied on the analysis in *Woodby* v. *INS*, *supra*, and on the traditional interpretation of the language in Section 7(c) of the APA. 43 S.E.C. at 459-460; see also 43 S.E.C. 852, 861 (1968) (after remand). The Commission noted (*id.* at 460; footnotes omitted):

> While the Exchange Act does not address itself specifically to the question of what degree of proof is required in an administrative proceeding, the Administrative Procedure Act ("APA"), which is applicable to proceedings under the Exchange Act, does. Section 7(c) of the APA provides that no rule or order shall be issued by an administrative agency except as supported by "the reliable, probative and substantial evidence." The standard has traditionally been held to be satisfied when the agency decides on the "preponderance of the evidence."

In accordance with Section 7(c) of the APA, the Commission repeatedly has employed or approved the use of the preponderance standard in administrative proceedings brought against securities industry personnel.[47]

In sum, this Court need not engage in an analysis of the relative advantages of the "preponderance of the evi-

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[47] See, *e.g.*, *In re Seaton*, 18 S.E.C. Docket 400, 401 n.6 (1979), petition for review pending, No. 79-2317 (D.C. Cir.); *In re Decker*, 15 S.E.C. Docket 1342 (1978), petition for review pending, No. 78-2008 (10th Cir.); *In re Schultz*, 15 S.E.C. Docket 860 (1978), aff'd, 614 F.2d 561 (7th Cir. 1980); *In re Investors Research Corp.*, 14 S.E.C. Docket 1020, 1026 n.30 (1978), aff'd in part, remanded in part, [Current] Fed. Sec. L. Rep. (CCH) ¶ 97,526 (D.C. Cir. 1980); *In re Abbett, Sommer & Co.*, 44 S.E.C. 104, 113-114 (1969), aff'd, [1970-1971] Fed. Sec. L. Rep. (CCH) ¶ 92,813 (D.C. Cir. 1970),

dence" and "clear and convincing evidence" standards in this context. Congress has already done so and has chosen the preponderance standard.

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cert. denied, 401 U.S. 974 (1971); *In re Cea*, 44 S.E.C. 8, 25 (1969); *In re Pollisky*, 43 S.E.C. 458 (1967), after remand, 43 S.E.C. 852, 860-861 & nn. 18-24 (1968); *In re DeMammos*, 43 S.E.C. 333, 337, aff'd, 23 Ad. L.2d 221 (2d Cir. 1967); *In re Underhill Securities Corp.*, 42 S.E.C. 689, 695 (1965). In certain situations subsequent to the D.C. Circuit's decision in *Collins*, the Commission has utilized the clear and convincing evidence standard in deference to the view of that court, which has venue of petitions for review of Commission orders. See, *e.g.*, 15 U.S.C. 80b-13(a).

Petitioner argues (Br. 26-27) that the fact that Congress has failed to enact legislation (in addition to the APA) that would approve use of the preponderance of the evidence standard in Commission proceedings "strengthens the inference" that Congress intended to require the clear and convincing evidence standard. Congressional intent cannot, however, be discerned from legislative inaction. *Boys Markets, Inc.* v. *Retail Clerks Local 770*, 398 U.S. 235, 241-242 (1970). See also *United States* v. *Board of Commissioners*, 435 U.S. 110, 135, 149 (1978); *NLRB* v. *Plasterers' Local 79*, 404 U.S. 116, 129-130 (1971). Furthermore, congressional action in this field was totally unnecessary following enactment of the APA in 1946. No circuit, except the D.C. Circuit within the last three years, has departed from the preponderance standard embodied in the APA (see notes 13-14, *supra*).

Petitioner also contends (Br. 25) that the silence of Congress as to a standard of proof in administrative disciplinary proceedings under the securities laws reflects an intention to adopt the clear and convincing evidence standard utilized in certain common law contexts. Petitioner points to nothing, however, which suggests that Congress had in mind the standard of proof used in those unrelated situations. See generally *TVA* v. *Hill*, 437 U.S. 153, 192 (1978).

III. The Decision Whether to Employ a Standard of Proof Greater Than the Preponderance of the Evidence Standard is Properly a Matter of Commission Discretion in the Circumstances of This Case.

1. As we have demonstrated above, Section 7(c) of the APA prescribes a preponderance of the evidence standard of proof. But, even if the APA did not prescribe a standard of proof, the Commission's decision to utilize the preponderance standard should be upheld. Since neither the Due Process Clause nor any other statute requires proof by more than a fair preponderance of the evidence, the decision whether to apply a higher standard is a discretionary decision of the administrative agency.

As this Court explained in *Mathews* v. *Eldridge, supra,* 424 U.S. at 348-349 (an adjudicatory proceeding involving termination of disability benefits):

> We reiterate the wise admonishment of Mr. Justice Frankfurter that differences in the origin and function of administrative agencies "preclude wholesale transplantation of the rules of procedure, trial, and review which have evolved from the history and experience of courts." *FCC* v. *Pottsville Broadcasting Co.*, 309 U.S. 134, 143 (1940). * * * In assessing what process is due in this case, substantial weight must be given to the good faith judgments of the individuals charged by Congress with the administration of [the statute] that the procedures they have provided assure fair consideration of the * * * claims of individuals. * * * This is especially so where, as here, the prescribed procedures not only provide the [individual] with an effective process for asserting his claim prior to any administrative action, but also assure a right to an evidentiary hearing, as well as to subsequent judicial review, before the denial of his claim becomes final.

Later, in *Vermont Yankee Nuclear Power Corp.* v. *Natural Resources Defense Council,* 435 U.S. 519, 524 (1978), this Court noted in a rulemaking proceeding that the procedural safeguards prescribed in the APA are "the maximum procedural requirements which Congress

was willing to have the courts impose upon agencies * * *." Accordingly, "[a]gencies are free to grant additional procedural rights in the exercise of their discretion, but reviewing courts are generally not free to impose them if the agencies have not chosen to grant them." The Court added that "this Court has for more than four decades emphasized that the formulation of procedures was basically to be left within the discretion of the agencies to which Congress had confided the responsibility for substantive judgments" (*ibid.*). See also *Costle* v. *Pacific Legal Foundation*, No. 78-1472 (Mar. 18, 1980), slip op. 16.[48]

The Court observed in *Vermont Yankee* that administrative agencies " 'should be free to fashion their own rules of procedure and to pursue methods of inquiry capable of permitting them to discharge their multitudinous duties' " absent "constitutional constraints or extremely compelling circumstances." 435 U.S. at 543.[49] Neither of these restrictions is present here. *Vance* v. *Terrazas*, *supra*, slip op. 13-14, confirms that the Due Process Clause does not require clear and convincing evidence in this context. And petitioner has failed to show any "compelling" reason why the risk of error in this case should not be borne equally by himself and the investors who

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[48] This judicial deference "is an outgrowth of the congressional determination that administrative agencies and administrators will be familiar with the industries which they regulate and will be in a better position than federal courts or Congress itself to design procedural rules adapted to the peculiarities of the industry and the tasks of the agency involved." *FCC* v. *Schreiber*, 381 U.S. 279, 290 (1965).

[49] The appropriate standard of proof is a procedural matter that many agencies address in their own rules of practice. See 16 C.F.R. 3.51(b)(3) (Federal Trade Commission); 16 C.F.R. 1025.51(b) (Consumer Product Safety Commission); 18 C.F.R. 1.38(k)(2), 1.40(i)(2) (Federal Energy Regulatory Commission); 29 C.F.R. 101.10(b)(1) (National Labor Relations Board).

have entrusted him with their money. Under these circumstances, the administrative agency's decision to use the preponderance standard should be affirmed.[50]

2. That the standard of proof in Commission adjudicative proceedings is not greater than the preponderance of the evidence does not mean that parties are afforded inadequate protection from unfair or erroneous agency action. As the court of appeals correctly concluded (Pet. App. 27-28), such protection is properly achieved not by requiring the Commission to apply a higher standard of proof, but by meaningful judicial review pursuant to Section 10(e) of the Administrative Procedure Act, 5 U.S.C. 706. See also 15 U.S.C. 78y(a), 80a-42(a), and 80b-13(a). Section 10(e) permits a reviewing court to set aside agency action that is arbitrary or capricious or that is not supported by substantial evidence.[51] Mean-

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[50] In imposing a clear and convincing evidence standard in cases of this kind, the D.C. Circuit's *Collins* decision erroneously relied on this Court's statement in *Woodby* v. *INS*, *supra*, that the standard of proof "is the kind of question which has traditionally been left to the judiciary to resolve." 562 F.2d at 824 (quoting 385 U.S. at 185). As previously noted (see note 44, *supra*), *Woodby* was not decided under the APA. Instead, it was decided under a statute that prescribed no standard of proof. Moreover, that case involved the "extreme deprivation" of deportation. In the present case, by contrast, the agency's standard of proof rests on the standard contained in the APA and no deprivation comparable to deportation is at issue.

[51] The Commission, like any other administrative agency, enjoys discretion in selecting a remedy that is appropriate to protect the public interest. When the agency adequately explains the reasons for the sanction that it selects, its decision will not be disturbed in the absence of a "patent abuse of discretion." *Moog Industries, Inc.* v. *FTC*, 355 U.S. 411, 414 (1958). Accord, *Butz* v. *Glover Livestock Commission Co.*, 411 U.S. 182, 185-187 (1973); *O'Leary* v. *SEC*, 424 F.2d 908, 911-912 (D.C. Cir. 1970); *Tager* v. *SEC*, 344 F.2d 5, 8-9 (2d

ingful review of the rationale for the severity of a sanction imposed by the Commission is assured by the requirement that the Commission "articulate carefully the grounds for its decision" (Pet. App. 27-28, 33-34).[52]

Cir. 1965); *Berko* v. *SEC*, 316 F.2d 137, 141-142 (2d Cir. 1963). This Court emphasized in *American Power & Light Co.* v. *SEC*, 329 U.S. 90, 113, 116, 118 (1946), that the choice of sanctions is uniquely a matter for agency determination. The Court stated that "where Congress has entrusted an administrative agency with the responsibility of selecting the means of achieving the statutory policy, 'the relation of remedy to policy is peculiarly a matter for administrative competence,'" and that a reviewing court would "imping[e] upon the Commission's rightful discretion were [it] to consider the various alternatives in the hope of finding one that [it] consider[s] more appropriate." *Id.* at 112, 118. In upholding an onerous order in that case, this Court did not suggest that a severe remedy requires extraordinary evidentiary standards.

[52] See generally *SEC* v. *Chenery Corp.*, 318 U.S. 80, 87, 94-95 (1943).

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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AUGUST 1980

APPENDIX

1. Sections 203(e) and (f) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-3(e) and (f), provide:

> (e) The Commisison, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any investment adviser if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such investment advisers, or any person associated with such investment adviser, whether prior to or subsequent to becoming so associated—
>
> (1) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein.
>
> (2) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any felony or misdemeanor which the Commision finds—
>
> (A) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, or conspiracy to commit any such offense;
>
> (B) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, investment adviser, bank, insurance company, or fiduciary;

(C) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities; or

(D) involves the violation of section 152, 1341, 1342, or 1343 or chapter 25 or 47 of title 18, United States Code.

(3) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, or municipal securities dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

(4) has willfully violated any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, this title, or the rules or regulations under any such statutes or any rule of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

(5) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, this title, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the pur-

poses of this paragraph (5) no person shall be deemed to have failed reasonably to supervise any person, if—

(A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(B) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

(6) is subject to an order of the Commission entered pursuant to subsection (f) of this section barring or suspending the right of such person to be associated with an investment adviser which order is in effect with respect to such person.

(f) The Commission, by order, shall censure or place limitations on the activities of any person associated or seeking to become associated with an investment adviser, or suspend for a period not exceeding twelve months or bar any such person from being associated with an investment adviser, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act or omission enumerated in paragraph (1), (4), or (5) of subsection (e) of this section or has been convicted of any offense specified in paragraph (2) of said subsection (e) within ten years of the commencement of the proceedings under this subsection, or is enjoined from any action, conduct,

or practice specified in paragraph (3) of said subsection (e). It shall be unlawful for any person as to whom such an order suspending or barring him from being associated with an investment adviser is in effect willfully to become, or to be, associated with an investment adviser without the consent of the Commission, and it shall be unlawful for any investment adviser to permit such a person to become, or remain, a person associated with him without the consent of the Commission, if such investment adviser knew, or in the exercise of reasonable care, should have known, of such order.

2. Section 9(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-9(b), provides:

> The Commission may, after notice and opportunity for hearing, by order prohibit, conditionally or unconditionally, either permanently or for such period of time as it in its discretion shall deem appropriate in the public interest, any person from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter, if such person—
>
> > (1) has willfully made or caused to be made in any registration statement, application or report filed with the Commission under this title any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such registration statement, application or report any material fact which was required to be stated therein; or
> >
> > (2) has willfully violated any provision of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of title II of this Act,

or of this title, or of any rule or regulation under any of such statutes; or

(3) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the Securities Act of 1933, or of the Securities Exchange Act of 1934, or of title II of this Act, or of this title, or of any rule or regulation under any of such statutes.

3. Sections 15(b)(4) and (6) of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*(b)(4) and (6), provide:

(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated—

(A) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this chapter, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein.

(B) has been convicted within ten years preceding the filing of any application for registra-

tion or at any time thereafter of any felony or misdemeanor which the Commission finds—

(i) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, or conspiracy to commit any such offense;

(ii) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, investment adviser, bank, insurance company, or fiduciary;

(iii) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities; or

(iv) involves the violation of section 152, 1341, 1342, or 1343 or chapter 25 or 47 of Title 18.

(C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, or municipal securities dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

(D) has willfully violated any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this chapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

(E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation

by any other person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this chapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if—

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

(F) is subject to an order of the Commission entered pursuant to paragraph (6) of this subsection (b) barring or suspending the right of such person to be associated with a broker or dealer.

* * * * *

(6) The Commission, by order, shall censure or place limitations on the activities or functions of any person associated, or seeking to become associated, with a broker or dealer, or suspend for a period not exceeding twelve months or bar any such

person from being associated with a broker or dealer, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act or omission enumerated in subparagraph (A), (D), or (E) of paragraph (4) of this subsection, has been convicted of any offense specified in subparagraph (B) of said paragraph (4) within ten years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of said paragraph (4). It shall be unlawful for any person as to whom such an order suspending or barring him from being associated with a broker or dealer is in effect willfully to become, or to be, associated with a broker or dealer without the consent of the Commission, and it shall be unlawful for any broker or dealer to permit such a person to become, or remain, a person associated with him without the consent of the Commission, if such broker or dealer knew, or in the exercise of reasonable care should have known, of such order.

4. Section 7(c) of the Administrative Procedure Act, 5 U.S.C. 556(d), provides in pertinent part:

> Except as otherwise provided by statute, the proponent of a rule or order has the burden of proof. Any oral or documentary evidence may be received, but the agency as a matter of policy shall provide for the exclusion of irrelevant, immaterial, or unduly repetitious evidence. A sanction may not be imposed or rule or order issued except on consideration of the whole record or those parts thereof cited by a party and supported by and in accordance with the reliable, probative, and substantial evidence.* * *

☆ U. S. GOVERNMENT PRINTING OFFICE: 1980 326010 50

Supreme Court, U. S.
FILED
NOV 15 1980
MICHAEL RODAK, JR., CLERK

No. 79-1266

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

CHARLES W. STEADMAN,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

PETITIONER'S REPLY BRIEF

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November 1980

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PETITIONER'S REPLY BRIEF

INTRODUCTION

Respondent's discussion of the issues presented by this case relies on two mistaken premises. First, respondent maintains that the Court lacks authority to establish or to recognize the clear and convincing standard of proof in SEC disciplinary proceedings. For reasons discussed in Part I, below, that contention cannot be sustained; neither the legislative history of the Administrative Procedure Act nor any doctrine of "agency discretion" provides support for respondent's argument.

Second, respondent's asserted "balancing" of the interests affected by the standard of proof is infirm. As demonstrated in Part II, below, respondent fails to recognize institutional factors and procedural advantages that tilt the probable outcome in SEC disciplinary proceedings heavily in favor of the government. Moreover, respondent fails to consider various aspects of the *public* interest that warrant a heightened standard of proof.

Before addressing those issues, however, one preliminary comment is in order. Departing even from its own brief supporting the petition for certiorari, respondent has attempted to alter fundamentally the issue presented to this Court for review. That issue, which has been endorsed by respondent and accepted by this Court, addresses the standard of proof required in SEC disciplinary proceedings to support findings of "violations of antifraud provisions of the federal securities laws . . ." SEC Br. Cert. 1-2. Yet, in its brief on the merits, respondent has limited the scope of the question to findings of "violations *by a fiduciary* of antifraud provisions . . ." SEC Br. i (emphasis added). That subtle but significant change is then used by respondent in an attempt to distort the underlying balance that is dispositive of the merits of this dispute.

Respondent's attempt to distort the issues in this manner cannot be sustained. The SEC has no authority whatsoever to consider breaches of fiduciary duty, if any, in finding violations of the securities laws. The Commission itself has acknowledged this prohibition, which was expressly reaffirmed by the Fifth Circuit below. *See* Pet. App. 31-32.[1] As a result, there has been no competent finding in this proceeding that Mr. Steadman breached any fiduciary duty with regard to the transactions at issue.

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[1] The Investment Company Act of 1940 "gives no power to the Commission, an administrative agency, to adjudicate such breaches, and the Commission has held that it cannot do so." Pet. App. 31 (citation omitted). Respondent has not sought review of this limitation of SEC authority.

Moreover, varying the standard of proof depending on the presence of fiduciary obligations makes little practical sense. The Commission itself admitted below that the "boundaries of the fiduciary concept are necessarily hazy. Much often depends on the particular factual setting and the precise questions presented." Pet. Supp. App. 100. There can be no justification for relaxing the standard of proof of violations in disciplinary proceedings based on a "hazy" notion that the Commission has no authority to address.[2]

I. NEITHER THE ADMINISTRATIVE PROCEDURE ACT NOR ANY GRANT OF "AGENCY DISCRETION" PROVIDES SUPPORT FOR THE PREPONDERANCE OF THE EVIDENCE STANDARD IN SEC DISCIPLINARY PROCEEDINGS.

A. Section 7(c) of the Administrative Procedure Act Does Not Address Standards of Proof.

Section 7(c) of the Administrative Procedure Act ("APA"), 5 U.S.C. § 556(d), provides that sanctions may not be imposed "except on consideration of the whole record . . . and in accordance with *the reliable, probative, and substantial* evidence" (emphasis added). Respondent contends that by this language, "Congress meant to endorse the traditional preponderance standard." SEC Br. 42. That contention, plainly

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[2] Respondent's obsessive efforts to characterize Mr. Steadman as a "faithless fiduciary" are similarly inappropriate. It is undisputed that the Funds have benefited substantially from petitioner's allegedly "faithless" conduct and that no one was harmed by petitioner's conduct. Moreover, the SEC rejected findings that petitioner had realized any benefit from the alleged violations. *See* Petr. Br. 14 n.18 and record sources cited there. Finally, respondent's inflammatory version of the facts — which unfairly and inaccurately characterizes Mr. Steadman as a sinister threat to the investing public — is disproved by the SEC's failure, during the ten years that this matter has been pending, to seek injunctive relief to protect the public from his purportedly egregious conduct. *See* pp. 11-12, *infra*.

in error, is refuted conclusively by this Court's prior decisions and by the unambiguous legislative history of the APA.

This Court has held that language virtually identical to that on which respondent relies pertains "not to the burden of proof, but rather to the quality and nature of the evidence upon which [an] order must be based." *Woodby* v. *Immigration and Naturalization Service,* 385 U.S. 276, 283 (1966) (addressing 8 U.S.C. § 1252(b)(4), which required "reasonable, substantial, and probative evidence" to support a deportation order). This Court concluded that by this language, "Congress has not addressed itself to the question of what degree of proof is required." *Id.* at 284.

There is no justification for reaching a contrary conclusion with regard to the virtually identical language of the APA. From the genesis of the phrase "reliable, probative and substantial evidence" in the legislative history,[3] through the legislative debates,[4] and until the post-enactment publication of

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[3] *See* Final Report of the Attorney General's Committee on Administrative Procedure, S. Doc. No. 8, 77th Cong., 1st Sess. 70-71 (1941) ("the ultimate test of *admissibility* must be whether the proffered evidence is *reliable, probative and relevant*") (emphasis added).

[4] "[S]ubsection 7(c) adopts the 'reliable, probative and relevant' standard stated by the Attorney General's Committee (Final Report, p. 71)." S. Doc. No. 248, 79th Cong., 2d Sess. 30 (1946). Substitution of the word "substantial" for "relevant" had no substantive significance. H. Rep. No. 1980, 79th Cong., 2d Sess. 53 n.18 (1946). For other pertinent indications from the legislative history that Section 7(c) addressed the quality of the evidence, *see, e.g.,* S. Rep. No. 752, 79th Cong., 1st Sess. 22, 28 (1945); Administrative Procedure: Hearings Before the Committee on the Judiciary of the House of Representatives, 79th Cong., 1st Sess. 35 (1945) (statement of Carl McFarland); 92 Cong. Rec. (Senate) 2159 (daily ed. March 12, 1946) (statement of Sen. McCarren).

the Attorney General's Manual on the Administrative Procedure Act,[5] the purpose of the language was clear: to regulate the *quality* — not the *quantity* — of the evidence required to support an administrative determination. This conclusion is reinforced by this Court's decision in *Woodby*.[6]

Finally, the APA by its own terms left open the possibility that a standard of proof more demanding than a mere preponderance may be imposed by a court. Thus, Section 12 of the original Act provided: "Nothing in this Act shall be held to diminish the constitutional right of any person or to limit or repeal additional requirements imposed by statute or otherwise recognized by law." *See* 5 U.S.C. § 559 (reflecting subsequent revisions to language but not to substance). Such rights and requirements, for the reasons set forth in our initial brief, warrant a heightened standard of proof. The APA provides no justification or basis for relaxing that standard.

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[5] The Attorney General's Manual, regarded as the most authoritative guide to interpretation of the APA, explicitly recognizes that Section 7(c) was intended to "restate the present law" with regard to the *quality* of the evidence to be considered in reaching administrative decisions. U.S. Dept. of Justice, Attorney General's Manual on the APA 76 (1947). For its source of "present law," the Attorney General's Manual cites Consolidated Edison Co. v. NLRB, 305 U.S. 197, 230 (1938), which required administrative orders to be justified by "evidence having rational probative force. Mere uncorroborated hearsay or rumor does not constitute substantial evidence."

[6] Thus, respondent's reliance on the *dissenting* opinion in *Woodby* is futile. *See* SEC Br. 42. Similarly, respondent's citation of a random phrase in the legislative history cannot undermine the unambiguous conclusion compelled by the evolution of the APA's language and its underlying concerns. *See* SEC Br. 42. There is no indication in the statute or in its legislative history that Congress even addressed the standard of proof, much less purported to resolve the issue for all administrative proceedings, even those authorized by statute after the APA's enactment.

B. Administrative Agencies Do Not Have Discretion To Determine The Standard Of Proof In Disciplinary Proceedings.

Respondent maintains that determining the appropriate standard of proof "is a discretionary decision of the administrative agency." SEC Br. 46. But that contention is undermined by the numerous decisions in which this Court, recognizing "the individual's interest in the outcome," has imposed a requirement of "proof more substantial than a mere preponderance" over the agencies' objections. *E.g., Addington* v. *Texas,* 441 U.S. 418, 427 (1979). *See* Petr. Br. 21 (citing cases). Thus, this Court has not permitted administrative agencies to usurp the function of determining the standard of proof, a function which "has traditionally been left to the judiciary." *Woodby, supra,* 385 U.S. at 284.

There is no justification for allowing such usurpation here. None of the authorities cited by respondent suggests otherwise. *Mathews* v. *Eldridge,* 424 U.S. 319 (1976) (SEC Br. 46), suggests only that with regard to certain procedural rules, weight may be given to the views of administrative agencies — but the decision itself still must be made by the courts. *Mathews, supra,* 424 U.S. at 330. *Vermont Yankee Nuclear Power Corp.* v. *NRDC,* 435 U.S. 519 (1978) (SEC Br. 46), is readily distinguishable for it involved a rulemaking proceeding, not a quasi-criminal adjudicatory proceeding with sanctions as severe as those proposed here. And, of course, neither case cited by respondent addressed the question of standard of proof, which lies peculiarly within the province of the judiciary to resolve. *Woodby, supra,* 385 U.S. at 284.

Further, in light of the compelling bases for inferring congressional preference for a "clear and convincing" standard, there is even less justification here than in ordinary circumstances for deferring to or accepting the agency's preference. *See* Petr. Br. 22-27. As it did in *Addington* and prior cases, this Court should reject the agency's unwarranted attempt to usurp the Court's authority with regard to standard of proof.

II. THE CLEAR AND CONVINCING STANDARD OF PROOF IS REQUIRED TO BALANCE THE COMPETING INTERESTS AND RISKS AFFECTED BY SEC DISCIPLINARY PROCEEDINGS.

In *Addington* v. *Texas,* 441 U.S. 418, 423 (1979), this Court recognized that the standard of proof "serves to allocate the risk of error between the litigants and to indicate the relative importance attached to the ultimate decision." Respondent's analysis of the risks and interests affected by SEC disciplinary proceedings is myopic at best. *First,* respondent erroneously assumes that the risks of error in SEC disciplinary proceedings are allocated equally by the preponderance of the evidence standard. That assumption is undermined by the severe imbalance between the SEC and those it seeks to discipline; this imbalance results from the SEC's substantial procedural and institutional advantages that are likely to effect an erroneous decision in the SEC's favor. *Second,* respondent completely ignores the *public* interest in avoiding the unwarranted removal of competent and honest investment advisors. That interest, coupled with the investment advisor's personal interest in avoiding an erroneous adverse decision, surely outweighs the government's interest in SEC disciplinary proceedings. *Third,* the government's interest in SEC disciplinary proceedings is diluted by the availability of alternative regulatory options that protect the investing public without presenting the grave risks and consequences of an adverse disciplinary order.

A. The Clear and Convincing Standard Of Proof Is Necessary Because Of The Substantial Institutional And Procedural Advantages Favoring The SEC.

Respondent's attempt to strike in its favor the balance required by *Addington* rests on a seductive but infirm premise: that the preponderance of the evidence standard allocates equally the risk of error between litigants. That premise may

be true with regard to certain kinds of civil litigation, where the pertinent rules and procedures apply equally to opposing parties. It plainly is not valid with regard to SEC disciplinary proceedings, where the SEC enjoys substantial institutional and procedural advantages over its disciplinary target. Absent a more demanding standard of proof, these advantages ensure that the accused in SEC disciplinary proceedings assumes a much greater risk of an erroneous decision than the government.[7]

The procedural advantages enjoyed by the Commission are both extensive and significant. While the Commission has substantial authority and resources with which to investigate alleged violations in anticipation of a disciplinary hearing (*see,*

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[7] The SEC contends that the clear and convincing standard would "interject serious inaccuracy in the administrative process." SEC Br. 20. That sophistic argument is dismissed by the very authorities on whom the Commission relies.

> "Which, of all various views and procedures, will produce the fewest mistakes in fact finding? *This is a question of fact which only investigation and experiment could really decide.*"

Ball, The Moment of Truth: Probability Theory and Standards of Proof, 14 Vand. L. Rev. 807, 829 (1961) (emphasis added, footnotes omitted). And, as this Court has acknowledged, "there are no directly relevant empirical studies. . . . [T]he ultimate truth as to how the standards of proof affect decisionmaking may well be unknowable . . . ." *Addington, supra,* 441 U.S. at 424-25.

Further, the Commission presumably has disproved its own remarkable contention that the clear and convincing standard of proof "would tend to cause more incorrect decisions than correct ones." SEC Br. 20 n.18. In each of the twenty disciplinary proceedings decided since the D.C. Circuit's decision in *Collins,* the Commission claimed that its findings of fact, supported by clear and convincing evidence, would not have varied if the preponderance standard had been applied. *See* Petr. Br. 9 n.10 (citing cases). While petitioner cannot determine whether those proceedings resulted in "more incorrect decisions than correct ones," it is absolutely clear that *the incremental burden of proof did not increase the number of "incorrect" results.*

e.g., 15 U.S.C. § 78u(a)), respondents in disciplinary proceedings have no rights to engage in pre-hearing discovery. *See, e.g., Charles M. Weber,* 35 S.E.C. 79 (1953), *aff'd,* 222 F.2d 822 (2d Cir. 1955). *See also* 17 C.F.R. § 201.8(d) (1980) (administrative law judges have *discretionary* option to allow respondents *limited* discovery). Respondents have no right to obtain exculpatory material held by the Commission unless it is likely to be introduced at trial,[8] they have no right to conduct discovery depositions or even to learn the identity of prospective Commission witnesses,[9] and they have no pre-hearing access to transcripts of the extensive *ex parte* depositions and interviews conducted by the Commission.[10]

Thus, the Commission has a substantial advantage in developing, discovering and protecting quantities of material that would create a "preponderance" of the evidence. *See generally* Freedman, A Civil Libertarian Looks at Securities Regulations, 35 Ohio St. L.J. 280 (1974). Absent parallel and equivalent opportunities for respondents, there is no assurance that the Commission's "preponderance" accurately reflects the underlying facts. To compensate for this imbalance and to

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[8] The Commission consistently has sustained the staff's refusal to recognize a respondent's entitlement to exculpatory material held by the Commission. *See generally* Mathews, Litigation and Settlement of SEC Administrative Enforcement Proceedings, 29 Cath. L. Rev. 215, 251 (1980).

[9] *See* 17 C.F.R. § 201.15(a) (1980) (allowing depositions by a respondent only if witness is unlikely to be able to attend the hearing); Dlugash v. SEC, 373 F.2d 107, 110 (2d Cir. 1967) (refusing access to witness lists).

[10] *E.g.,* Haight & Co., 44 S.E.C. 481, 510-11, *aff'd,* No. 71-637 (D.C. Cir. 1971), *cert. denied,* 404 U.S. 1058 (1972). *See* 17 C.F.R. § 201.11.1 (1980) (allowing, in limited circumstances, access to pre-hearing statements only *after* the witness has offered direct testimony).

minimize its effect on the accuracy of Commission findings, a more demanding standard is required.[11]

The need for a more demanding standard is even more compelling in light of the questionable quality of evidence admissible in SEC disciplinary proceedings.[12] Because the SEC's "proof" of a violation may include hearsay, conjecture or other incompetent evidence, the *weight* of the evidence in such hearings may be substantially distorted. Administrative law judges "admit all evidence that 'can conceivably throw any light upon the controversy,'" "even though it might be inadmissible before a jury because too remote or conjectural to be properly evaluated by lay triers of fact." *Clinton Engines Corp.*, 41 S.E.C. 408, 411-12 (1963) (footnotes omitted). To ensure an accurate and fair result, a heightened standard of proof is therefore necessary to compensate for the *quality* of the evidence underlying SEC findings of fact.[13] As this Court has

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[11] Contrary to respondent's suggestion, the "extended hearing procedure" in SEC enforcement actions does not "guarantee[] the accuracy . . . of the ultimate result." SEC Br. 25. The objective of the Commission's adjudicatory procedure is "not accuracy," but a balance between "fairness, efficiency and acceptability." 2 K. Davis, Administrative Law Treatise § 10:4 pp. 319, 321 (2d ed. 1979). As a result, "many of the rules . . . are not geared for, but are often aptly suited to defeat, the development of the truth." Frankel, The Search for Truth: An Umpireal View, 123 U. Pa. L. Rev. 1031, 1036 (1975). The rules limiting discovery by SEC respondents, discussed *supra* at pp. 8-9, amply demonstrate this fact.

[12] Although the Commission's decision must be "in accordance with the reliable, probative and substantial evidence," 5 U.S.C. § 556(d), there is no limitation on the admissibility of evidence not meeting those standards.

[13] On certain technical issues, the Commission's expertise may diminish the misleading effect of incompetent evidence. More frequently, however, the Commission possesses no special expertise with regard to crucial factual issues. *See, e.g.*, Klopp v. SEC, 427 F.2d 455, 460 (6th Cir. 1970). This is particularly true with regard to the factual issues in dispute below, such as whether Steadman's alleged statutory violations were willful. *See* Petr. Br. 17-19.

recognized, "[i]ncreasing the burden of proof is one way to impress the factfinder with the importance of the decision and thereby perhaps to reduce" erroneous decisions through more careful scrutiny of the evidence. *Addington*, 441 U.S. at 427.

B. Respondent's Purported Balance Of The Competing Interests Is Inadequate.

Respondent maintains that the appropriate standard of proof should be determined by only two factors: (1) petitioner's interest in avoiding unwarranted imposition of devastating sanctions and (2) the investing public's interest in avoiding dishonest investment advisors. SEC Br. 15-16. On this basis, respondent concludes that the risks of an erroneous decision should be allocated equally between the parties.

But respondent's perception of the competing interests is infirm in at least two respects. First, the analysis fails to address the investing public's interest in avoiding the unwarranted removal or disqualification of a competent and honest investment advisor. That interest, which is at least as weighty as the public's interest in avoiding dishonest investment advisors,[14] is illustrated by the investors who since 1971 have invested in Steadman-managed Funds despite the pendency of these proceedings. Petitioner submits that these competing public interests are approximately equal. Petitioner's personal interest in avoiding an unwarranted adverse decision tips the scale firmly in favor of a more demanding standard of proof. *See generally* Brief of Amicus Securities Industry Association at 10-11.

Second, the "public interest" in protecting investors *through disciplinary sanctions* is far narrower than respondent suggests. The Commission need not rely on disciplinary proceedings to protect investors from the harms caused by unscrupulous investment advisors or unethical investment prac-

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[14] *See, e.g.*, S. Rep. No. 94-75, 94th Cong., 1st Sess. 8 (1975) (emphasizing the public interest in competition among investment advisors and brokers).

tices. For example, the Commission may seek injunctive relief, for which proof by only a preponderance of the evidence may be sufficient.[15] Alternatively, the Commission may publish information concerning violations for the benefit of injured or prospective investors. 15 U.S.C. § 78u(a). The public can thus be protected from harm even if the government is unsuccessful in the disciplinary forum.[16] For the investment advisor who is disciplined improperly, however, there is no alternative forum for *de novo* protection of his interests.[17]

The narrow scope of the government's interest in disciplinary sanctions is particularly apparent in this proceeding. Despite the Commission's harsh characterizations of Mr. Steadman and his conduct, the government has not sought to protect the "public interest" by pursuing against Mr. Steadman injunctive remedies or seeking other relief. *See* p. 3, n. 2, *supra.* The government's failure to pursue alternative available remedies should not be a basis for relaxing the standard of proof in disciplinary proceedings that, unlike the regulatory alternatives, entail grave and irremedial consequences for the individuals involved.

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[15] *See* SEC v. Savoy Industries, Inc., 587 F.2d 1149, 1169 (D.C. Cir. 1978), *cert. denied,* 440 U.S. 913 (1979).

[16] Respondent implies that recognition of a heightened standard of proof in SEC disciplinary proceedings would inhibit government action in other areas. SEC Br. 28. But unlike the imposition of SEC disciplinary sanctions, each government action cited by respondent is the *exclusive* means of protecting the public from a specific harm. Similarly, in Vance v. Terrazas, 100 S. Ct. 540 (1980), expatriation was the only means by which the government could deny the rights of an American national to one who had sworn allegiance to a foreign state. In contrast, the government may protect the investing public by numerous regulatory devices that do not entail punitive sanctions.

[17] The Commission's reliance on SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) is thus misplaced. *See, e.g.,* SEC Br. 30. *Capital Gains* addressed an injunctive action — not a disciplinary proceeding entailing severe sanctions.

In short, the standard of proof should be determined by weighing the following interests: (a) petitioner's interest in avoiding the unwarranted imposition of grievous harm and drastic punishment, (b) the public interest in avoiding the unwarranted removal of honest and competent investment advisors, and (c) the public interest in obtaining *by disciplinary sanctions* protection from dishonest or incompetent investment advisors. We respectfully submit that any reasonable balance of those interests warrants a standard of proof that allocates to the government the greater risk of error.

CONCLUSION

For the foregoing reasons and for the reasons set forth in petitioner's opening brief, the judgment below should be reversed and the cause remanded to the Commission with directions to dismiss all allegations against petitioner.

Respectfully submitted,

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November 1980

Supreme Court, U. S.
FILED
JUL 15 1980
MICHAEL RODAK, JR., CLERK

No. 79-1266

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

CHARLES W. STEADMAN,
Petitioner

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE NATIONAL COMMITTEE OF DISCOUNT SECURITIES BROKERS AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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THE CASILLAS PRESS, INC.–1717 K Street, N. W.–Washington, D. C.–223-1220

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BRIEF FOR THE NATIONAL COMMITTEE OF DISCOUNT SECURITIES BROKERS AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF THE NATONAL COMMITTEE OF DISCOUNT SECURITIES BROKERS

The National Committee of Discount Securities Brokers ("Committee") is an *ad hoc* group of securities brokers who are registered as broker-dealers with the Securities and Exchange Commission ("Commission") pursuant to Section 15 of the Securities Exchange Act of 1934. 15 USC §78o. As such, the members of the Committee are subject to the antifraud provisions of the federal securities laws as well as the disciplinary authority of the Commission under Section 15(b) of the 1934 Act. 15 USC §78o(b). Section 15(b) disciplinary authority is exactly

parallel to the Commission's disciplinary authority over investment advisers under Section 203(f) of the Investment Adviser's Act of 1940, 15 USC §80b-3(f), that is at issue in the case at bar. Accordingly, the members of the Committee have a substantial and immediate interest in the question now before the Court of whether in an administrative proceeding before the Commission, violations of the antifraud provisions of the federal securities laws must be proved by clear and convincing evidence, rather than by a preponderance of the evidence. For this reason the Committee wishes to file a brief *amicus curiae* in support of the position of petitioner, Charles W. Steadman.[1]

As *amicus curiae,* we are concerned with the broad policy implications of this case. It glaringly presents the abuse of discretion and warping of authority by which the Commission over the years has lifted itself by its own bootstraps from exercising the limited regulatory powers granted to it by Congress to an omniscient exerciser of what can only be called the equivalent of Article III judicial powers. The Committee urges the Court in deciding this case to hold that because of common law principles, the Fifth Amendment and the statutory considerations discussed hereinbelow, that the Commission must apply the clear and convincing standard of proof in administrative proceedings as to *each element* of the alleged violations under all three subsections of Section 17(a) of the 1933 Act, and as well under Subsections (1) and (2) of Section 206 of the Advisers Act.

The policy justification for such a holding lies primarily in the nature of the securities industry, the overlapping, in-

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[1]Counsel for the Committee, Carl L. Shipley, is also general counsel of Steadman Security Corporation and the five mutual funds managed by Steadman Security Corporation. Mr. Steadman, petitioner herein, is the chairman and president of each of these entities.

terlocking, obscure and tangled provisions of the federal securities laws, and the Houdini-like escape of the Commission from the bounds of authority which Congress thought it had enacted in the 1933 and 1940 Acts. Such unrestrained exercise of power by the Commission brings to mind principles first enunciated by Thomas Jefferson when he wrote:

> "In questions of power, then, let no more be heard of confidence in man, but bind him down from mischief by the chains of the Constitution."[2]

In light of the "tangled web" of the securities laws and the regulations thereunder and the sometimes over-zealous way in which they are enforced by the Commission, the Committee submits that the imposition of the clear and convincing standard is a proper and necessary means to protect the constitutional rights of the citizen from the "stealthy encroachments" feared by Justice Bradley in ***Boyd v. United States,*** 116 U.S. 616, 635. The Committee believes that this burden must be imposed for the reasons stated by this Court in *Jones v. Securities and Exchange Commission,* 298 U.S. 1 (1935):

> "The philosophy that constitutional limitations and legal restraints upon official action may be brushed aside upon the plea that good, perchance, may follow, finds no countenance in the American system of government." (*Id.* at 27.)

While the case at bar deals with one man and one set of circumstances, the Committee believes that it is important to bring to the Court's attention the inequities involved therein because they affect every member of the Commit-

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[2]P.L. Ford, "The Writings of Thomas Jefferson", Volume VII, 1795-1801, G.P. Putnam's Sons, New York, 1896, page 306.

tee who must work in the environment regulated by the Commission.

The outcome of this case affects not only the members of the Committee who are but a few of the 6,246 brokers and dealers registered with the Commission, some of whom are among the 5,664 investment advisers similarly registered, but it will affect many others. For example, there are 1,552 publicly owned companies whose shares are traded on the New York Stock Exchange, 964 on the American Stock Exchange, and 197 on the other stock exchanges, as well as 30,000 whose shares are traded in the over-the-counter market. All of these companies, and all other companies with assets in excess of $1 million and 500 or more public shareholders, are required to file annual reports with the Commission, send reports to their shareholders, and provide investors with prospectuses whenever they issue and distribute securities to the investing public. In addition, these companies send proxy statements to their shareholders each year. All of these documents are required to be filed with the Commission and are subject to the antifraud provisions of the federal securities laws.

Although the Commission proceeding involving Steadman was brought under Section 9(b) of the Investment Company Act of 1940 (15 USC §80a-9(b)), and Section 203(f) of the Investment Advisors Act of 1940 (15 USC §80b-3(f)), the Commission has similar broad discretionary enforcement powers under all of the securities acts. The impact of this decision respecting the requisite degree of proof will provide guidance to the entire securities industry.

SUMMARY OF ARGUMENT

The Securities and Exchange Commission has entered an order that imposes an economic death sentence on Petitioner. This drastic sanction was inflicted on the basis of a mere preponderance of the evidence. Because of the drastic nature of the sanction and because it is based upon allegations of fraud, the Commission should be required to prove its findings by clear and convincing evidence. There is ample precedent for the imposition of this higher standard of proof.

In light of the tangled web of federal securities laws and regulations that often are not susceptible to common understanding and the sometimes over-zealous manner in which the Commission enforces these laws and regulations, the clear and convincing standard of proof should be required with respect to every element involved in the particular offense alleged.

The facts of this case illustrate that the clear and convincing standard is necessary to prevent the Commission from reaching inequitable and unjust results by straining and torturing the common sense meaning of statutory language. This standard of proof is also necessary to prevent unjust and inequitable results occasioned by the Commission's reliance on Sections 17(a)(2) and (3) instead of Section 17(a)(1) of the Securities Act of 1933 thereby avoiding proof of scienter or any awareness of wrongdoing.

ARGUMENT

THE CLEAR AND CONVINCING STANDARD OF PROOF SHOULD BE IMPOSED ON THE COMMISSION WITH RESPECT TO EVERY ELEMENT INVOLVED IN THE OFFENSE ALLEGED

The Securities and Exchange Commission has imposed on Charles Steadman the economic death sentence of permanent debarment from the investment company advisory industry.[3] The Commission has done so on the basis of findings supported merely by a preponderance of the evidence. Specifically, it found (1) that the four mutual funds for which Steadman Security Corporation ("SSC") acts as investment adviser did not disclose in their prospectuses that both Steadman and SSC had loans from the Chase Manhattan Bank in New York, the custodian of the assets of the mutual funds; (2) that the potential for abuse by virtue of Steadman's influence over where the mutual funds did their banking was sufficiently great that, in the Commission's opinion, shareholders would want to know about such loans; (3) that this collateral banking relationship was material information that the mutual funds had a duty to reveal; (4) that the funds' failure to disclose this information was caused by and aided and abetted by Steadman; and (5) that this failure to disclose was a violation of Section 17(a) of the Securities Act of 1933 (15 USC §77q(a)) and Sections 206(1) and (2) of the Investment Advisers Act of 1940 (15 USC §80b-6).[4]

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[3]The Committee is directly interested in the Commission's power to impose such drastic sanctions under the Investment Advisers Act of 1940 because its members are subject to this same power under Section 15(b) of the Securities Exchange Act of 1934. 15 USC §78o(b).

[4]On appeal the United States Court of Appeals for the Fifth Circuit granted in part and denied in part Steadman's petition for review, set aside the Commission's order and remanded the cause for reconsidera-

The question presented to the Court contains several lesser included questions which are ripe for review and important to a resolution of the problems existing in the securities industry because of uncertainty as to the Commission's administrative burden of proof in enforcing the antifraud provisions of the federal securities laws.

One of these important lesser included questions involves whether the clear and convincing standard should be imposed on the Commission with respect to every element involved in the offenses alleged. In this case the Commission built its case not on employment of any "device, scheme or artifice to defraud" under Section 17(a)(1), not on "engaging in any transaction, practice, or course of business which operates or could operate as a fraud or deceit" under Section 17(a)(3), not on obtaining "money or property by means of any untrue statement of a material fact" under clause one of Section 17(a)(2), but on the very nebulous accusation under clause two of 17(a)(2) that Steadman personally caused and aided and abetted an "omission to state a *material fact* necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading" (emphasis added) in the mutual funds' prospectuses.

The "material" fact at issue is Steadman's collateral banking relationship. Importantly however, this Court

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tion consistent with its opinion. The Fifth Circuit held, however, that the Commission properly applied a preponderance of the evidence standard of proof. This is directly contrary to *Collins Securities Corp. v. Securities and Exchange Commission,* 562 F2d 820 (D.C.Cir.1977) and *Whitney v. Securities and Exchange Commission,* 604 F2d 676 (D.C.Cir.1979), both of which hold that no permanent or substantial debarment from the securities industry may be imposed in an administrative proceeding by the Commission, regardless of the circumstances, unless the alleged violations are proven by clear and convincing evidence.

may judicially notice that neither Congress by statute nor the Commission by regulation has ever afforded Steadman, similarly situated persons or anyone else in the industry, any notice[5] that the mere existence of a collateral banking relationship between an officer or director of a public corporation and a commercial bank with which the corporation does business, in the absence of any conflict, is nonetheless a material fact required to be disclosed at the peril of being debarred from the securities industry for fraud.

When neither Congress by statute nor the Commission by rule has put officers and directors on notice that such collateral banking relationships constitute "material" information within the meaning of clause 2 of Section 17(a)(2) and amount to "engaging in a transaction, practice, or course of business which operates as a fraud" within the meaning of Section 206(2) of the 1940 Advisers Act, fairness requires that the question of materiality be determined on the basis of clear and convincing evidence.[6] The Commission can trigger its power to debar, as it did in this case, merely by finding a material omission. In order

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[5]In contrast, Congress provided specifically in Schedule A of the Securities Act of 1933, 32 items of material information to be included in a prospectus. 15 USC §77. Furthermore, a prospectus must contain "such other information as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors." 15 USC §77j. This regulatory scheme properly provides notice of those matters which the Commission and the Congress consider important to the investing public.

[6]"The issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts. . . . The determination requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact." *TCS Industries, Inc. v. Northway, Inc.*, 426 U.S. 406, 450 (1976).

properly to safeguard against abuse of this power, the Commission shold be required to prove that an omission was material by clear and convincing evidence.

With respect to the allegedly "material fact" at issue here, close analysis reveals that it was not material at all. The Commission made no finding that Steadman's self-interest in currying the good favor of the bank induced him to keep large amounts of the funds' cash in non-interest bearing checking accounts. On the contrary, the Division of Enforcement never even alleged that checking account balances were ever excessive and the Commission specifically refused to make such a finding. *Steadman v. Securities and Exchange Commission*, 603 F2d 1126, 1130 (5th Cir.1979). The Commission's findings were merely based on the *theory* that the loans had created the *potential* for maintaining excessive account balances.[7] *Id.* Had the Commission been required to prove by clear and convincing evidence that failure to disclose the collateral banking relationships was a "material omission", a different result would have ensued.[8]

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[7]The truth of the matter is that the record establishes that the mutual funds benefitted by more than an $800,000 savings in custodian fees as a result of transferring the funds' accounts to banks with which Steadman happened to have collateral relationship.

[8]The Commission's "theory" and "speculation" as to the effect of the collateral banking relationship finds absolutely no support even as a practical matter. This Court may judicially notice that all major corporations keep substantial amounts of cash in non-interest bearing accounts for a variety of reasons. One such common reason is to obtain more favorable interest rates on loans taken down by the corporation involved. Certainly the officers and directors of these corporations have loans outstanding from the banks involved. Yet the Commission cannot conceivably assert that these loans should be disclosed. It is simply common business practice. Disclosure of this nature would, for a large corporation, encompass pages and pages and impose an outrageous and unmerciful burden.

A second lesser included question is whether the Commission must prove by clear and convincing evidence that *Steadman* caused or aided and abetted the *mutual funds* in filing and disseminating prospectuses which omitted the information concerning the collateral banking relationships. Steadman did not file or disseminate prospectuses, the mutual funds did. Section 6(a) of the 1933 Act (15 USC §77f) requires the issuer to file a registration statement — not Steadman. The corporate funds were the "issuers". Steadman was but one member of the board each of whom signed the registration statement and shared responsibility for disclosure. Section 10(a) of the 1933 Act makes *every person* who signs liable, but Section 11(c) is a safe-harbor for signers who exercise prudent and reasonable care as to the prospectuses' disclosure. The funds acted through their boards of directors and officers, who relied on information furnished by legal and accounting professionals. The Court may judicially notice that prospectuses relating to securities are highly technical documents, prepared by experienced lawyers, independent public accounts and employees of the *issuer,* not any particular officer or director.[9]

If there was a material omission in the prospectus, the responsibility must be placed with the corporate mutual funds, not with Steadman or any other individual officer or director absent specific proof to the contrary by clear and convincing evidence.

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[9]The Securities Act of 1933, which requires an effective registration statement containing a prospectus as a condition precedent to the distribution of securities, provides in pertinent part: "Any securities may be registered with the Commission . . . by filing a registration statement in triplicate, at least one of which shall be signed by each *issuer,* its principal executive officer . . . its principal financial officer, its comptroller . . . and the majority of its board of directors." (15 USC §77f) (Emphasis added.)

The members of the boards of directors of the mutual funds at the time of the alleged violations (1968) were men of outstanding reputation and business experience.[10] Most served on the boards of many corporations. They had decades of experience as corporate directors. It is not reasonable that these men, experienced as they were in the responsibilities of serving as corporate directors, would stand by idly and allow Steadman to cause the corporations which they served to omit material information from prospectuses prepared by legal and accounting counsel in behalf of such corporations. It is sheer speculation to assume that Steadman, as one individual, usurped the business judgment of such men as to disclosure or anything else.

Respondents argued below that Steadman had a "duty" to disclose his collateral banking relationship. However, the SEC can point to no such statutory or regulatory duty. How can there be a duty to disclose a commonplace practice in the business world – a non-conflicting collateral banking relationship – when neither Congress nor the SEC have enumerated it among the forseeable material

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[10]The directors and some of their affiliations are set forth below:

Edward R. Farley, Jr. – Chairman and President of the Atlas Corp. (mining and manufacturing); Trustee, Lincoln Savings Bank (Brooklyn); **Robert W. Fleming** – Investment Banker; Executive Vice-President and Director, Folger Nolan Fleming Douglas, Inc. (members NYSE); Director, Interstate Federal Building Association; Director, Acacia Mutual Life Insurance Co.; Director, Security Storage Co.; **Frederick M. Glass** – Vice-Chairman of the Board, Empire State Bldg. Corp.; Executive-Vice President and Director, Hertz Corp.; President and Director, National Car Rental System, Inc.; Chairman, Cosmos American Corp.; Director and Vice-Chairman, Cosmos Bank (Zurich); President and Director, Cosmos Equity Corp.; President and Director, Prudential Group, Inc.; **Joseph P. Kazickas** – President and Director, Neris Carbon & Oil Corp.; Director, Cosmos Bank (Zurich); **Harry C. Mills** – Retired; formerly Vice-President and Director, J.C. Penney Co.

disclosure items (Schedule A, 1933 Act, SEC Form N-1, 17 CFR 239.15)?

There are probably 50,000 publicly owned corporations in the U.S. If each has an average of 10 directors, that suggests a half million directors. These are matters of common knowledge. Most commercial banks require compensating non-interest bearing balances as a condition of commercial loans. This is a particularly prevalent fact of business life for securities brokers. In addition, corporations have trust, mortgage, pension plan, and other banking relationships. The business reality is that businessmen who are engaged in substantial activities would find it virtually impossible not to have a collateral relationship with some bank with which corporations also have a relationship. Fraud should depend on actual, not potential conflicts. The SEC should not be permitted to back into a fraud charge (Section 17(a)(2) "omission") by elevating a non-material bit of information to the level of materiality, and then perceiving its disclosure as a "duty" for a non-issuer under Section 6(a), without meeting at least a clear and convincing standard. And can a "potential" risk of abuse of a power to maintain excessive cash in non-interest bearing accounts on the part of one person who, as one officer and director of a corporation with many officers and directors, ever be "material" for SEC disclosure purposes? We submit such a theory is so unlikely it must be supported by clear and convincing evidence when debarment is the penalty for non-disclosure. Without a "duty" to disclose the relationship, there can be no liability. Because this is an essential element of the alleged offsense, the Committee submits that it too must be proved by clear and convincing evidence. Under the facts of the case, however, the Commission could not possibly have proven a duty to disclose by any standard of proof much less by clear and convincing evidence. Whether one has a duty to disclose what might

later be labeled a material omission depends upon the individual's state of mind at the time, i.e., whether he had any specific intent or "awareness of wrongdoing." See *Investors Research Corp. v. Securities and Exchange Commission,* No. 78-1597 (D.C. Cir., decided April 29, 1980). The Commission's own findings establish that Steadman had no "awareness of wrongdoing" at the time. If the potential for abuse existed, no such abuse was alleged or proved.[11] Wrongdoing requires a wrongful intent implemented by a wrongful act. Every corporate officer and director is capable of a myriad of "potential" wrongs – misappropriation, embezzlement, larceny, forgery – but the SEC has never required anyone else to catalog in a prospectus all of the potential risks of conflict. Why Steadman?

Had the Commission been required to prove by clear and convincing evidence that a duty to disclose existed, what the Committee believes to be an unjust and inequitable result would not have ensued.

The Commission also found that Steadman had aided and abetted a violation of Section 15(a)(1) of the Investment Company Act (15 USC §80a-15(a)(1)) which prohibits an adviser from receiving "compensation" not "precisely" described in the advisory contract between the advisory company and the mutual fund. SSC's contract with two of the mutual funds limited its annual advisory fee to 1% of average net assets. The fee was payable monthly based on estimates of average net assets. Because

[11]The Commission made no finding that Steadman's self-interest in currying the good favor of the banks induced him to keep large amounts of the funds' cash in non-interest bearing accounts. On the contrary, the Division of Enforcement never alleged that checking account balances were excessive and the Commission specifically refused to make such a finding. *Steadman v. SEC,* 603 F2d 1126, 1130 (5th Cir.1979).

assets declined sharply near the end of the fiscal year, accounting revealed that SSC owed the two funds $260,000 in refundable fees. This was simply an account payable by Steadman Security Corporation and an account receivable to the mutual fund. The directors in an exercise of prudent good faith business judgment fixed 6% interest on the account receivable and approved a repayment arrangement. Thus, it was like unrealized appreciation and other accounts receivable, reflected in the fund's daily net asset value. (17 CFR 270.2a-4; SEC Rule SX, Art. 6, 6-03). An account receivable in accordance with usual accounting practice and SEC rules cannot be "compensation" because the SEC staff develops some self-serving theory contrary to the facts and law. Surely the barrier of clear and convincing evidence should be erected to protect the industry from such semantic contortions.

The Commission found that Steadman's failure to disclose the repayment arrangement was a violation of the antifraud provisions. In so doing it contorts the board's good faith business judgment into a failure to disclose "compensation" by Steadman (when SSC, not Steadman, was the advisor) in order to "get" Steadman under Section 15, a gross abuse of administrative power.

Because the aiding and abetting findings were bootstrapped by the Commission into antifraud violations which resulted at least in part in the debarment order, the Committee believes that the aiding and abetting violations must be supported by clear and convincing evidence. That this evidentiary safeguard is needed to protect against the Commission abuses discussed above is made clear by the fact that the Commission did not even find that the allegedly omitted fact was a material one. *Steadman v. SEC, supra* at 1135. The District of Columbia Circuit has

recently restated the requirement that an aiding and abetting charge by the SEC must be supported by proven awareness of wrongdoing. *Investors Research Corp. v. SEC,* No. 78-1597 (D.C. Cir., April 29, 1980). This Court should establish, in addition, the clear and convincing standard for aiding and abetting.

Without such protection, the Commission has a free rein to do precisely what it did in this case – strain and torture the common sense meaning of "compensation" to achieve its own purposes. All that was involved here was a fee overrun that was contemplated by the advisory agreement. The agreement was silent, however, as to the method or timing of such repayments. No law or rule says that such overruns must be repaid at the time they are accounted for.

There was no impropriety here, no dishonesty, no wrongdoing. For financial accounting purposes the overrun was treated like an account receivable and was in the nature of unrealized appreciation, with one difference – SSC was paying the funds 6% interest on the obligation.[12] In this regard it is important to note that unrealized appreciation, other accounts receivable and many common stock dividends in the portfolio yield less than 6%.

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[12]The 6% interest was higher than 5% passbook savings rates and was compatible with commercial loan interest rates at the time. Moreover, the decision as to interest rate, time of repayment, and other details are the kinds of internal management decisions confided by state law to the directors, who in this case approved the arrangement. *Cort v. Ash,* 422 U.S. 66 (1974); Sec. 141, Del. Corp. Law (the Steadman funds were Delaware corporations).

The Commission attempts to hold Steadman personally liable for a business judgment made by the boards of directors in an exercise of their good faith business judgment in accordance with state law. E.g., Del. Gen. Corp. Law §141. This fact alone should have precluded the imposition of liability on Steadman in light of this Court's holdings in *Cort v. Ash,* 422 U.S. 66 (1974) and *Sante Fe Industries v. Green,* 430 U.S. 462 (1976).

The Commission also found that Steadman and Republic Securities Corporation, a wholly-owned broker-dealer subsidiary of SSC, had aided and abetted violations of Section 17(e) of the Investment Company Act (15 USC §80a-17(e)) by receiving tender solicitation fees in connection with the tender of shares held by the funds and not remitting the fees to the funds. Here again the Committee submits that this is a lesser included question which, as well, must be proven by clear and convincing evidence because it is part and parcel of the findings which ultimately resulted in the imposition of the bar.

Section 17(e)(1) precludes an investment company, acting as agent, from receiving compensation for the purchase or sale of property to or for such company "except in the course of such person's business as an underwriter or broker." The record in this case plainly establishes that RSC in connection with the tender solicitation "did the same things that an unaffiliated broker would have had to do had the task been assigned to it." *Steadman Securities Corp.,* CCH Fed. Sec. L. Rep. ¶ 10, 107, Dec. 20, 1974, p. 13,084. RSC provided a forwarding service, a transaction service or part of a transaction service for which it was entitled to share in the fee.[13]

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[13]The transaction seized upon by the Commission was typical in the industry. It is termed a "give-up" under the rules of the New York Stock Exchange and it involves nothing more than a correspondent

Had the Commission been required to prove by clear and convincing evidence that RSC aided and abetted violations of Section 17(e) the Committee believes that the Commission could not have sustained its burden of proof.

By straining the common sense meaning of statutory language and avoiding proof of scienter, and relying on subsections (a)(2) and (a)(3) instead of (a)(1) of Section 17 of the 1933 Act, the Commission can proceed practically unrestrained to the entry of debarment orders. The Com-

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relationship where more than one broker is involved in the transaction. It is merely a method by which fees are divided –

> "A broker who surrenders a portion of his commission to another is said to "give up" the surrendered portion. "Give-ups" are of two kinds. One kind, the traditional correspondent relationship, involves a division of compensation where there has been an actual division of labor among two or more brokers in the handling of a particular transaction. Thus, if a broker who has secured a customer through personal contact, investment advice, or by providing custodial or other services, receives an order from that customer which he is unable to execute because he has no executing and clearance facilities of his own, he can forward the order to a second broker for execution and clearance. The second broker may execute the order himself. However, he may be too busy on the exchange floor with other orders, and in these circumstances he will delegate the actual execution to a floor broker who spends all of his working time on the floor and who specializes in executing orders for other brokers but does not maintain office facilities necessary to clear them. The commission may be divided among the broker who obtained the order, the second broker who arranged for the delivery of the securities from the seller's broker and handled much of the paperwork, and the floor broker who made the actual purchase on the exchange floor. Give-ups resulting from traditional correspondent relationships have not posed basic regulatory problems."
>
> (Report of the SEC on the PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, 89th Congress, 2d Sess., H.R. No. 2337)

mittee believes that the imposition of the clear and convincing evidentiary standard is necessary to protect against the nearly unbridled with which the Commission is able to impose the most serious sanction at its disposal, often with seemingly reckless abandon for the dire consequences such a penalty has on its target.

The Committee urges the Court to reject the Fifth Circuit's holding that in SEC disciplinary proceedings violations of the antifraud provisions of the federal securities laws can be proved by a mere preponderance of the evidence instead of by clear and convincing proof. The Committee submits that the proper approach to this issue has been taken by the District of Columbia Circuit in *Collins Securities Corp. v. SEC,* 562 F2d 820 (D.C.Cir.1977) and *Whitney v. SEC,* 604 F2d 676 (D.C.Cir.1979).

The D.C. Circuit's requirement of clear and convincing proof has ample support in precedent. This Court has recently held that the clear and convincing standard of proof is required in civil commitment proceedings. *Addington v. Texas,* 441 U.S. 423 (1979). The Court's rationale in requiring the higher degree of proof in *Addington* – the possibility of deprivation of liberty and the creation of a stigma – is equally applicable to the case at bar where Steadman faces exclusion from his chosen profession as well as the stigma inherent in fraud accusations.

The consequences for Steadman of debarment from the investment advisory industry is not much different in effect than if he had been sent to jail. In jail he would be locked in – in this case he is locked out; not only locked out of the investment advisory business, but locked out for "fraud", with all of its opprobrious and sinister implications of dishonesty in a case where no dishonesty is alleged. As a practical matter, he is locked out of even being an officer or director of any publicly owned corporation, and

he may even be disbarred as a lawyer and locked out of that calling.[14] A securities fraud finding locks the target respondent out of almost every significant area of business life, as well as seriously damaging personal reputation.

The realities of business life are such that Steadman will be wiped out as a result of the Commission's action in this case. On the broader spectrum the same thing happens to every other person who is subjected to the heavy artillery the Commission can bring to bear in making fraud allegations, finding fraud on the basis of a mere preponderance of the evidence, and then blowing the respondent away with permanent debarment.

Because allegations of fraud have such drastic and dire consequences, other courts have traditionally imposed the clear and convincing standard of proof. See *Woodby v. Immigration Service,* 385 U.S. 276, 285 (1966); *United States v. American Bell Telephone Co.,* 167 U.S. 224 (1897); *Maxwell Land-Grant Case,* 121 U.S. 325 (1887).

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[14]Steadman has been a member of the bar for 41 years, since he was graduated from the Harvard Law School. His reputation for trustworthiness and responsibility in the business world stand to be wiped out. Mr. Steadman has a long and distinguished career as a lawyer, a corporate executive, and the author of legal and economic articles. He has served, *inter alia,* as Chief of the Legal Division of the War Department's Cleveland Ordnance District with the rank of Lieutenant Colonel, Chief Counsel for the Senate Select Committee for Contribution Investigation (84th Congress), and Chairman of the Board of Directors of the Endowment Fund for Distinguished Teaching of the University of Nebraska. He has been a member of the Board of St. Vincent Charity Hospital and Chairman of the Cotillion Society of Cleveland. He received the University of Nebraska Distinguished Service Award in 1960. He has been actively involved in the American Bar Association, chairing various committees and serving on others, and he has authored several legal articles. This heretofore unblemished career stands to be smeared on the basis of a mere preponderance of the evidence. (See *Who's Who in America,* 1979 p. 3098)

The application of the clear and convincing standard also finds direct support in cases imposing disciplinary sanctions on attorneys because the result is the same – exclusion from one's profession. See *In re Fisher,* 179 F2d 361 (7th Cir.), *cert. denied,* 340 U.S. 825 (1950); *In re Ryder,* 263 F.Supp. 360 (E.D.Va.), *aff'd,* 381 F2d 713 (4th Cir.1976); *Charlton v. Federal Trade Commission,* 543 F2d 903 (D.C.Cir.1976).

In light of this precedent and in view of the serious consequences that befall anyone who is debarred from the securities industry on grounds of fraud, the Committee submits that the Commission should not be allowed to inflict such grevious harm on the basis of a preponderance of the evidence.

CONCLUSION

Apart from the above considerations, the Committee believes that the Commission should bear the burden of proving by clear and convincing evidence that the penal sanction it proposes to impose in barring individuals from the securities industry is necessary in the "public interest". The Commission's power to impose sanctions is not unlimited. A sanction is authorized only upon a finding that it is necessary in the public interest. 15 USC §80a-9(b). This case presents a clear example of how the "public interest" standard in Commission administrative proceedings somehow gets tossed on the ash heap. The Committee believes that this case demonstrates the gross inappropriateness of the sanctions that are often imposed by the Commission. (E.g., *Investors Research Corp. v. SEC,* No. 78-1597 (D.C. Cir., April 29, 1980) (where censure was the sanction for actual, not potential, diversion of fund assets to pay for computer services for the adviser.)

There has been no finding in this case that anyone has been hurt by the alleged violations. The mutual funds have not been hurt – they benefitted from the custodianship transfers and the expense overruns were repaid at commercial interest rates.

No one has gained from the alleged violations. Steadman's loans from the Chase Manhattan Bank were made at normal interest rates, neither Steadman nor SSC were accorded favorable treatment by the banks, the loans were obtained on the basis of Steadman's ability to repay and they were adequately collateralized. In short, the loans were normal, everyday business arrangements that Steadman simply considered a private matter, which along with many other private details, are not normally made public or discussed with business associates. The loans were irrelevant to Steadman's relationship to the mutual funds.

Given all of these facts, the Committee finds it difficult to rationalize how the Commission could possibly justify the destruction of debarment as being necessary in the public interest. The Committee believes that this is an instance wherein the Court should set aside the penalty imposed.[15]

This case has been going on for nearly a decade during which Steadman has lived under a cloud which has interferred seriously with all his business operations and he has incurred legal expenses approaching one-half million dollars. The Committee respectfully submits that this is an appropriate instance for the Court to dispose of the matter now by dismissing the case or remanding it to the Fifth

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[15] 5 USC §§551(10), 551(3), 702 and 706 authorize such review. Moreover, the courts have traditionally undertaken to review and limit SEC sanctions. E.g., *Arthur Lipper Corp. v. SEC*, 547 F2d 171 (2d Cir.1976); *Beck v. SEC*, 430 F2d 673 (6th Cir.1970); *Quinn & Co. v. SEC*, 452 F2d 943 (10th Cir.1971), *cert.den.*, 406 U.S. 957 (1972).

Circuit to take appropriate steps to dismiss the proceeding. It seems plain that Steadman has suffered enough. Here the administrative process has been punishment enough.

The judgment below should be reversed.

Respectfully submitted,

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July 1980

Supreme Court, U. S.
FILED
JUL 15 1980
MICHAEL RODAK, JR., CLERK

No. 79-1266

IN THE
Supreme Court of the United States
OCTOBER TERM, 1980

CHARLES W. STEADMAN,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR SECURITIES INDUSTRY ASSOCIATION AS *AMICUS CURIAE*

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BRIEF FOR SECURITIES INDUSTRY ASSOCIATION AS *AMICUS CURIAE*

QUESTIONS PRESENTED

1. Whether, in disciplinary proceedings before the Securities and Exchange Commission, which frequently result in permanent exclusion from the securities industry as well as other harsh sanctions, willful violations of anti-fraud provisions of the federal securities laws must be proved by clear and convincing evidence, rather than by a mere preponderance of the evidence.

2. Whether the Administrative Procedure Act requirement that the Securities and Exchange Commission justify with particularity the sanctions it imposes is an adequate substitute for clear and convincing evidence to support a Commission finding of willful securities fraud violations.

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INTEREST OF THE SIA AS *AMICUS CURIAE*[1]

The Securities Industry Association ("SIA") is a national trade association representing approximately 500 brokers and dealers responsible for over 90 percent of the securities brokerage and investment banking business of the nation. Its membership is located throughout the United States and represents a broad cross section of the securities industry, including members of every national securities exchange as well as securities firms not members of the exchanges.

SIA's members perform a complete spectrum of professional securities activities, including retail and institutional brokerage, over-the-counter market-making, underwriting and other investment banking activities, various exchange floor functions, money management and investment advisory services with respect to corporate, municipal, government, and foreign securities. The SIA is generally recognized as a principal spokesman for the securities industry before legislative, regulatory, and judicial bodies.

The issue of the quantity of evidence required to sustain a Securities and Exchange Commission ("SEC" or "Commission") disciplinary order against one of the broad range of professionals in the securities industry is of utmost importance to the SIA and its members. The SIA cooperates with the SEC, the stock exchanges, and other self-regulatory organizations in sponsoring numerous programs to educate its members and others with respect to compliance with the applicable securities laws. Nevertheless, given the complexities of the securities laws, disputes over the propriety of conduct by securities

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[1] All parties have consented to the filing of this brief for *amicus curiae* in support of Petitioner. *See* letter from the Solicitor General to Counsel for SIA, dated May 23, 1980, and letter from Counsel for Steadman to Counsel for SIA, dated June 5, 1980, copies of which have been filed with the Clerk of this Court.

professionals will arise. In the adjudication of such disputes, based as they frequently are on broad, vague statutory anti-fraud provisions, there is a higher than normal risk of an erroneous result. The standard of proof in SEC disciplinary proceedings determines the extent to which industry professionals must bear that risk. The SIA believes that the SEC's application of the clear and convincing evidence requirement in its disciplinary proceedings since the decision in *Collins Securities Corp.* v. *SEC*, 562 F.2d 820 (D.C. Cir. 1977), has added substantially to the fairness of such proceedings and the resulting sanctions. Consequently, the SIA urges this Court to reverse the Court of Appeals' conflicting decision in this case because that decision, if allowed to stand, will increase the risk of unfair disciplinary proceedings with unwarranted sanctions and thus undermine public confidence in the justice of such proceedings.

STATEMENT

Petitioner Charles W. Steadman is president, chairman of the board, and sole beneficial owner of all the voting stock of Steadman Security Corporation ("SSC"), a registered investment adviser. SSC, either directly or through wholly owned subsidiaries, advises and manages several mutual funds known collectively as the Steadman Funds. In June 1971, the SEC instituted an administrative disciplinary proceeding against Steadman, SSC, and the subsidiaries, alleging willful violations of several provisions of the federal securities laws.

Over petitioner's objection that a more rigorous standard of proof was required,[2] the SEC found, by a mere preponderance of the evidence, that petitioner and SSC had willfully violated or aided and abetted violations of the anti-fraud provisions of Section 17(a) of the Se-

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[2] *Steadman Security Corp.*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,243 at 88,339-19 n.88 (June 29, 1977).

curities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, and Sections 206(1) and (2) of the Investment Advisers Act of 1940. On the basis of these findings, the SEC (1) permanently barred Steadman from associating with any investment adviser, (2) prohibited him from affiliating with any registered investment company, and (3) suspended him for one year from associating with any broker or dealer.[3]

Upon review, the United States Court of Appeals for the Fifth Circuit held that a mere preponderance of the evidence was sufficient to sustain the SEC's findings of willful fraud violations.[4] However, noting that the SEC had imposed the most severe sanctions at its disposal, the Fifth Circuit remanded with directions that the Commission "articulate a sufficient justification" for ordering petitioner's expulsion from the industry.

SUMMARY OF ARGUMENT

The SEC asks this Court to reinstate the pre-*Collins* standard to permit the SEC to bar permanently broker-dealers, investment advisers, underwriters and other securities industry personnel from their chosen professions, although the SEC is unable to find clear and convincing evidence that the professional respondent willfully violated anti-fraud provisions of the federal securities laws.

As this Court has repeatedly recognized, any adjudication of fact can be erroneous, and the function of the standard of proof is to allocate the risk of an erroneous result between the government and the target of government disciplinary action. The preponderance of the evidence—or more likely than not—standard, applied by the SEC and affirmed below, improperly places upon industry

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[3] *Id.* at 88,339-23.

[4] *Steadman* v. *SEC*, 603 F.2d 1126 (5th Cir. 1979).

professionals substantial and unwarranted risks of erroneous adjudication of willful fraud and the unfair imposition of harsh sanctions.

A clear and convincing evidence standard is appropriate because SEC disciplinary proceedings are penal or quasi-criminal in nature. The possible sanctions, including license revocation, suspension and permanent bar from the securities industry, constitute harsh penalties that are analogous to disbarment of a lawyer. In addition, these disciplinary proceedings almost always involve ambiguous or inferential evidence and the "willful fraud" stigma that have traditionally led courts, including this one, to require clear and convincing proof.

The court below, applying settled principles of judicial administration, properly required the SEC to justify with particularity the sanctions imposed. Justifying the severity of the particular sanction imposed does not, however, eliminate the need for clear and convincing proof of a willful fraud violation. Application of an erroneous standard of proof in making the underlying finding of a willful violation of the anti-fraud provisions will undermine the fairness of the proceeding regardless of the sanction. Exclusive reliance on judicial review of the sanction would also enable the SEC to extract settlements from persons who would not otherwise be charged. Because judicial review of the choice of sanction is traditionally narrow, it is not a substitute for the correct standard of proof of a willful violation.

ARGUMENT

The SEC conducts administrative disciplinary proceedings pursuant to several statutes and its own rules of practice.[5] It has broad powers to impose severe sanc-

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[5] *See, e.g.*, §§ 8(d) and (e) of the Securities Act of 1933, 15 U.S.C. § 77(d) and (e) (1976); §§ 15(b)(4) and (6), 15(c)(4), 15A and 19(h) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o(b)(4) and (6), § 78o(c)(4) (1976), 15 U.S.C.

tions. The SEC can permanently bar a person from being registered as, or associated with, a broker, dealer, investment adviser, or investment company upon a finding that the person has willfully violated, or willfully aided and abetted violations of, the federal securities laws, or willfully made false or misleading statements in reports filed with the SEC. Although lacking express statutory authority, the SEC also claims and frequently exercises the power to bar from practice before it lawyers,[6] accountants,[7] and other professionals whom it finds to have willfully violated, or willfully aided and abetted others in violating, the federal securities laws.

Neither statute nor SEC rule specifies the standard of proof necessary in such proceedings, that issue being left for resolution through case law development.[8] Before

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§ 78o-3, s(h) (1976); § 203(e) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-3 (1976); and §§ 8, 9, and 41 of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-8, 80a-9, 80a-41 (1976); 17 C.F.R. § 201.2(e) (1979); *see also* 3 L. Loss, Securities Regulation 1891-1944 (2d ed. 1961); 6 L. Loss, Securities Regulation 4020-4078 (2d ed. Supp. 1969); Mathews, *Litigation and Settlement of SEC Administrative Enforcement Proceedings*, 29 Cath. U.L. Rev. 215, 220-26 (1980).

[6] *See, e.g., Kivitz* v. *SEC*, 475 F.2d 956 (D.C. Cir. 1973), *rev'g Murray A. Kivitz*, 44 S.E.C. 600 (1971); *Schwebel* v. *Orrick*, 153 F. Supp. 701 (D.D.C. 1957), *aff'd*, 251 F.2d 919 (D.C. Cir.), *cert. denied*, 356 U.S. 927 (1958); *Morris Mac Schwebel*, 40 S.E.C. 347 (1960); *Keating, Muething & Klekamp*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,124 (July 2, 1979) (particularly dissenting opinion of SEC Commissioner Karmel); *William R. Carter*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,175 (March 7, 1979) (initial decision), *appeal pending before SEC*.

[7] *See, e.g., Touche Ross & Co.* v. *SEC*, 609 F.2d 570 (2d Cir. 1979).

[8] *See, e.g., Woodby* v. *INS*, 385 U.S. 276, 284 (1966) (The appropriate standard of proof "is the kind of question which has traditionally been left to the judiciary to resolve. . . .").

the decision in *Collins* v. *SEC*, 562 F.2d 820 (D.C. Cir. 1977) [hereinafter cited as *Collins*], the SEC applied the mere preponderance or "more likely than not" standard in its disciplinary proceedings. It did so even when the respondent was charged with willful violations of the anti-fraud provisions of the federal securities laws and faced the possible sanction of permanent exclusion from his chosen profession.[9]

In affirming the SEC's use of the "more likely than not" standard, the Fifth Circuit expressly declined to follow the *Collins* decision, in which Judge Wilkey, joined by Judges Leventhal and Wright, held that "a realistic correlation between the burden of persuasion and the available remedies" required application of the "clear and convincing" standard in SEC disciplinary proceedings involving allegations of willful fraud and the potential for serious sanctions.[10] The Fifth Circuit failed to acknowl-

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[9] *See Harold T. White*, 3 S.E.C. 466, 539-40 (1938), where the Commission adopted the mere preponderance standard even though it held its administrative disciplinary proceedings were "closely analagous to proceedings for the collection of a statutory penalty." *See also Steadman Security Corp.*, [1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,243 at 88,339-19 n.88 (June 29, 1977); *Norman Pollisky*, 43 S.E.C. 458, 459-60 (1967); *James De Mammos*, 43 S.E.C. 333, 337 (1967), *aff'd mem.* (2d Cir., Oct. 13, 1967); *Harris Clare & Co.*, 43 S.E.C. 198 (1966); *Underhill Securities Corp.*, 42 S.E.C. 689 (1965); *Richard N. Cea*, 44 S.E.C. 8, 25 (1969); *Associated Sec. Corp.* v. *SEC*, 283 F.2d 773 (10th Cir. 1960); *Pierce* v. *SEC*, 239 F.2d 160 (9th Cir. 1956); *Wright* v. *SEC*, 112 F.2d 89 (2d Cir. 1940); *Abbett, Summer & Co.*, 44 S.E.C. 104 (1969), *aff'd sub nom. Abbett, Summer & Co.* v. *SEC*, [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,813 (D.C. Cir. 1970) (*per curiam*), *cert. denied*, 401 U.S. 974 (1971); *Aircraft Dynamics Int'l Corp.*, 41 S.E.C. 566 (1963); *MacRobbins & Co.*, 40 S.E.C. 497, *remanded on other grounds sub nom. Berko* v. *SEC*, 297 F.2d 116 (2d Cir. 1961).

[10] 562 F.2d at 826.

edge that in *Whitney* v. *SEC*, 604 F.2d 676 (D.C. Cir. 1979), the District of Columbia Circuit had reaffirmed and extended *Collins*, holding that "any sanction imposed under section 15(b) [of the Securities Exchange Act of 1934] which depends on a finding of fraud must be sustained by clear and convincing evidence." [11] In addition, the Fifth Circuit apparently gave no weight to the SEC's application of the clear and convincing standard in a number of post-*Collins* administrative disciplinary proceedings involving brokers,[12] investment advisers,[13] and lawyers.[14] Nor did the Fifth Circuit note that other administrative agencies, relying on the reasoning in *Collins*, have applied the clear and convincing standard in disciplinary proceedings.[15] After the *Steadman* decision, the

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[11] 604 F.2d at 681 (footnote omitted). The *Whitney* court severely rebuked the SEC for taking "an overly parsimonious view of our rationale in *Collins*." *Id.*

[12] *E.g., Allen & Co.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,174 at 82,163 (Aug. 2, 1979) (initial decision); *Thomas A. Sartain*, SEC 1934 Act Release No. 16,561 (Feb. 8, 1980); *J.A.B. Sec. Co.*, SEC 1934 Act Release No. 15,948 (June 25, 1979).

[13] *E.g., Hinkle Northwest, Inc.*, SEC 1934 Act Release No. 15,338 (Nov. 16, 1978); *International Research & Management Corp.*, SEC Investment Advisers Act Release No. 617 (March 6, 1978). In each of these proceedings, the SEC declined to determine whether *Collins* governed but nevertheless found clear and convincing evidence of violations.

[14] *William R. Carter*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,175 at 82,165 & n.3 (March 7, 1979) (initial decision), *appeal pending before SEC.*

[15] *See, e.g., Harold Collins*, [1977-80 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,910 (1979) (CFTC administrative proceeding); *Compania Salvadorena de Cafe, S.A.*, CFTC Docket No. 79-34, 518 Sec. Reg. & L. Rep. (BNA) A-16 (August 29, 1979) (CFTC administrative proceedng). *See also Delikosta* v. *Califano*, 478 F. Supp. 640, 643-44 n.4 (S.D.

District of Columbia Circuit also applied the clear and convincing standard with respect to findings of willful fraud in a broadcast license revocation proceeding before the Federal Communications Commission. *Sea Island Broadcasting Corp.* v. *FCC*, No. 76-1735 (D.C. Cir., Jan. 14, 1980).[16] The decision below thus departs from an unmistakable trend toward application of the clear and convincing standard in willful fraud cases involving potentially severe sanctions.

Respondents in SEC disciplinary proceedings are entitled to procedural fairness.[17] In the realm of fact find-

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N.Y. 1979) (HEW administrative proceedings to reopen an award of social security benefits because of alleged fraud should be governed by clear and convincing standard).

[16] In several securities disciplinary proceedings subsequent to *Collins*, parties have raised the issue of the applicable standard of proof on appeal, but the courts have declined to resolve the issue. *E.g.*, *Shultz* v. *SEC*, 614 F.2d 561, 569 n.17 (7th Cir. 1980) ("The issue of what standard we would use in a case involving fraud is not before us."); *Sartain* v. *SEC*, 601 F.2d 1366, 1371-72 (9th Cir. 1979) (court declined to resolve issue because it was not timely raised). *See also Investors Research Corp.* v. *SEC*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,366 at 97,445 n.41 (D.C. Cir., April 29, 1980), *language modified on another point*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 97,526 (D.C. Cir., June 11, 1980) (court declined to require application of clear and convincing standard in SEC proceeding involving neither fraud nor severe sanctions); *Chatham* v. *SEC*, 604 F.2d 1368 (D.C. Cir. 1978) (*per curiam*) (court declined to resolve issue because SEC's ruling was reasonable under either standard of proof); *Nassar & Co.* v. *SEC*, 566 F.2d 790, 794 n.2 (D.C. Cir. 1977) (Leventhal, J., concurring) (SEC, while maintaining that mere preponderance standard should govern, did find clear and convincing evidence).

[17] *See SEC* v. *Sloan*, 436 U.S. 103 (1978); *cf. Silver* v. *New York Stock Exchange*, 373 U.S. 341 (1963); *Intercontinental Indus., Inc.* v. *American Stock Exchange*, 452 F.2d 935 (5th Cir. 1971), *cert. denied*, 409 U.S. 842 (1972).

ing, procedural fairness encompasses both allocating the burden of proof to the proper party [18] and selecting the appropriate standard of proof to balance the risk of erroneous decisions with other societal interests in each particular type of adjudication.[19]

A standard of proof "represents an attempt to instruct the factfinder concerning the degree of confidence our society thinks he should have in the correctness of factual conclusions for a particular type of adjudication." [20] As the Court noted last term, a particular standard of proof "serves to allocate the risk of error between the litigants and to indicate the relative importance attached to the ultimate decision." [21]

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[18] *See Mathews* v. *Eldridge*, 424 U.S. 319 (1976); *Speiser* v. *Randall*, 357 U.S. 513 (1958).

[19] The precise standard of proof appropriate to a particular type of adjudication "is embodied in the Due Process Clause and in the realm of factfinding. . . ." *Addington* v. *Texas*, 441 U.S. 418, 423 (1979). Since SEC administrative disciplinary sanctions are imposed pursuant to federal statute—the federal securities laws—determination of the applicable standard of proof in this case need not rest on constitutional grounds but simply upon the judicial responsibility properly to administer litigation. *Woodby* v. *INS*, 385 U.S. 276, 284 (1966); *see also United States* v. *Fatico*, 458 F. Supp. 388, 408 (E.D.N.Y. 1978), *aff'd*, 603 F.2d 1053 (2d Cir. 1979), *cert. denied*, 100 S. Ct. 1018 (1980).

[20] *In re Winship*, 397 U.S. 358, 370 (1970) (Harlan, J., concurring).

[21] *Addington* v. *Texas*, 441 U.S. 418, 423 (1979). This Court has recognized four separate standards of proof: (1) beyond a reasonable doubt; (2) clear, unequivocal and convincing; (3) clear and convincing; and (4) mere preponderance. Beyond a reasonable doubt, the most stringent standard, applies in criminal prosecutions. *Mullaney* v. *Wilbur*, 421 U.S. 684 (1975); *In re Winship*, 397 U.S. 358 (1970); *Holt* v. *United States*, 218 U.S. 245, 254 (1910). Clear, un-

The preponderance of the evidence test advocated by the SEC allocates to the respondent in an SEC disciplinary proceeding a substantial risk—only marginally better than the flip of a coin [22]—that the government will

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equivocal and convincing, an intermediate but stringent standard, applies in extraordinary civil cases "where the various interests of society are pitted against restrictions on the liberty of the individual . . . ." *In re Ballay*, 482 F.2d 648, 662 (D.C. Cir. 1973). *E.g.*, *Woodby* v. *INS*, 385 U.S. 276 (1976) (deportation); *Chaunt* v. *United States*, 364 U.S. 350 (1960) (denaturalization); *Baumgartner* v. *United States*, 322 U.S. 665 (1944) (denaturalization); *Schneiderman* v. *United States*, 320 U.S. 118, 125, 159 (1943) (denaturalization); *Nishikawa* v. *Dulles*, 356 U.S. 129 (1958) (expatriation); *Gonzales* v. *Landon*, 350 U.S. 920 (1955) (*per curiam*) (expatriation). Clear and convincing, another intermediate but less stringent standard, has been applied in civil cases that involve significant charges that imply moral turpitude and substantial sanctions that "can engender adverse social consequences to . . . [and] have a very significant impact on the individual." *Addington* v. *Texas*, 441 U.S. 418, 425-26 (1979) (civil commitment). *See, e.g.*, *Gertz* v. *Robert Welch, Inc.*, 418 U.S. 323, 331-32 (1974) (libel); *Rosenbloom* v. *Metromedia, Inc.*, 403 U.S. 29, 50-52 (1971) (libel); *Tippett* v. *Maryland*, 436 F.2d 1153, 1165-66 (4th Cir. 1971), *cert. dismissed sub nom. Murel* v. *Baltimore City Criminal Court*, 407 U.S. 355 (1972); *cf. United States* v. *Fatico*, 458 F. Supp. 388, 404 (E.D.N.Y. 1978), *aff'd*, 603 F.2d 1053 (2d Cir. 1979), *cert. denied*, 100 S. Ct. 1018 (1980). Mere preponderance, the least stringent standard, applies to "the typical civil case involving a monetary dispute between private parties," *Addington* v. *Texas*, 441 U.S. at 423, where the courts "view it as no more serious in general for there to be an erroneous verdict in the defendant's favor than for there to be an erroneous verdict in the plaintiff's favor." *In re Winship*, 397 U.S. 358, 371-72 (1970) (Harlan, J., concurring).

[22] The "preponderance of the evidence" standard of proof "simply requires the trier of fact 'to believe that the existence of a fact is more probable than its nonexistence . . . .'" *In re*

make an erroneous finding of willful fraud and consequently impose a penalty that can be as severe as total, permanent deprivation of profession, business and livelihood. Such a distribution of the risk of erroneous adjudication is wrong. It fails to recognize the weight the law has traditionally accorded to the interests of those facing severe sanctions and to the interests of those accused of willful fraud.[23] It also fails to accord any weight to the public interest in ensuring that salutary economic activity is not inhibited by either an actual erroneous adjudication of willful fraud or the perception that such an erroneous adjudication is likely. In contrast, the clear and convincing test recognizes these interests while reconciling them with the legitimate public interest in effective enforcement of the federal securities laws against those who are convincingly shown to have committed willful fraud violations.

Winship, 397 U.S. 358, 371 (1970) (Harlan, J., concurring) (citing F. James, *Civil Procedure* 250-51 (1965)). *See also* McBaine, *Burden of Proof: Degrees of Belief*, 32 Calif. L. Rev. 242, 261 (1944); *United States* v. *Fatico*, 458 F. Supp. 388, 403 (E.D.N.Y. 1978) (in which Judge Weinstein quantifies the various standards of proof "along a continuum from low probability [50+ percent probable] to very high probability [95+ percent probable]"), *aff'd*, 603 F.2d 1053 (2d Cir. 1979), *cert. denied*, 100 S. Ct. 1018 (1980); *United States* v. *Schipani*, 289 F. Supp. 43, 56-57 (E.D.N.Y. 1968), *aff'd*, 414 F.2d 1262 (2d Cir. 1969), *cert. denied*, 397 U.S. 922 (1970).

[23] There is ample precedent for requiring clear and convincing evidence to support *either* a finding of willful fraud, *see, e.g., Lalone* v. *United States*, 164 U.S. 255, 257 (1896); *Whitney* v. *SEC*, 604 F.2d 676 (D.C. Cir. 1979), or imposition of a drastic sanction, *see, e.g., Woodby* v. *INS*, 385 U.S. 276 (1976). The fact that this case, like *Collins*, involves both allegations of willful fraud and the most severe sanctions, provides an overwhelming basis for requiring clear and convincing evidence.

I. THE INTERESTS OF RESPONDENTS IN SEC "QUASI-CRIMINAL" DISCIPLINARY PROCEEDINGS IN WHICH THEY FACE SEVERE SANCTIONS REQUIRE THE USE OF THE "CLEAR AND CONVINCING" STANDARD OF PROOF.

Historically, where an administrative or disciplinary body has sought to impose severe sanctions, this Court has as a minimum required proof of the violation by clear and convincing evidence. In *Schneiderman* v. *United States*, 320 U.S. 118 (1943), the Court held that "the clearest sort of justification" was required to support the drastic sanction of revocation of citizenship.[24] In *Gonzales* v. *Landon*, 350 U.S. 920 (1955) (*per curiam*), this Court applied the same standard in an expatriation action.[25] In *Woodby* v. *INS*, 385 U.S. 267, 282-86 (1966), the Court held that the Immigration and Naturalization Service had to have "clear, unequivocal and convincing evidence" to order deportation. Noting the "drastic deprivations" resulting from deportation, this Court rejected the government's contention that the non-criminal

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[24] 320 U.S. at 122. In *Schneiderman*, the Court drew an analogy between public land grants and the grant of citizenship to the naturalized citizen by quoting with approval language from *Johannessen* v. *United States*, 225 U.S. 227 (1912):

> [A] certificate of citizenship is "an instrument granting political privileges and open like other public grants to be revoked if and when it shall be found to have been unlawfully or fraudulently procured." . . . To set aside such a grant the evidence must be "clear, unequivocal and convincing"—"it cannot be done upon a bare preponderance of evidence which leaves the issue in doubt."

320 U.S. at 125. The case at bar similarly could be characterized as an attempt to revoke a "public grant"—*i.e.*, the grant of a license to do business in the securities industry.

[25] *See also Nishikawa* v. *Dulles*, 356 U.S. 129 (1958) (expatriation).

nature of the proceeding permitted a preponderance standard of proof "no higher . . . than applies in a negligence case." [26] The Court added that the clear, unequivocal and convincing standard "is no stranger to the civil law" and "has traditionally been imposed in cases involving allegations of civil fraud." [27]

As recently as last term, the Court in *Addington* v. *Texas*, 441 U.S. 418, 431 (1979), held that in civil commitment proceedings the states must apply at least a clear and convincing standard—a "middle level of burden of proof that strikes a fair balance between the rights of the individual and the legitimate concerns of the state."

This Court has also repeatedly recognized that administrative deprivation of a person's employment is a drastic sanction or punishment that triggers a panoply of procedural and constitutional protections. The Court has held that a person may not be deprived of his employment as a state political party officer,[28] a public contractor,[29] a police officer,[30] or a city sanitation worker [31] without a wide range of protections, including procedural due process, the Fifth Amendment right against self-incrimination, and other safeguards.

Although loss of particular employment is a severe sanction, it is not nearly so drastic as total preclusion from a chosen profession.[32] In cases involving exclusion

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[26] 385 U.S. at 285.

[27] 385 U.S. at 285 n.18.

[28] *Lefkowitz* v. *Cunningham*, 431 U.S. 801 (1977).

[29] *Lefkowitz* v. *Turley*, 414 U.S. 70 (1973).

[30] *Gardner* v. *Broderick*, 392 U.S. 273 (1968); *Garrity* v. *New Jersey*, 385 U.S. 493 (1967).

[31] *Uniformed Sanitation Men Ass'n* v. *Commissioner of Sanitation*, 392 U.S. 280 (1968).

[32] *See* Friendly, *Some Kind of Hearing*, 123 U. Pa. L. Rev. 1267, 1297 (1975). Judge Friendly noted that the revocation of a license to practice a profession ranks "high on the pro-

from a profession such as government service[33] or the practice of law,[34] this Court has imposed even higher standards, approaching those applicable in criminal felony trials. In implementing the protections afforded against permanent loss of profession, several federal courts have required "clear and convincing evidence" rather than the "more likely than not" standard advocated by the SEC. For example, where attorneys are subject to disciplinary proceedings, courts have recognized that disciplinary sanctions, even those designed for the protection of the public, severely punish the attorney, often destroying both professional reputation and livelihood.[35] Therefore, proof of the misconduct must be clearly and convincingly shown.[36]

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cedural scale," because "the government is threatening to deprive a person of a way of life to which he has devoted years of preparation and on which he and his family have come to rely," and "the types of issues often resemble those tried in actions for fraud or negligence, or even in criminal proceedings." *Id.* (footnotes omitted).

[33] *United States* v. *Lovett*, 328 U.S. 303 (1946) (Permanent proscription from government service is a "punishment" that can be inflicted lawfully only upon compliance with the Sixth Amendment).

[34] *In re Ruffalo*, 390 U.S. 544 (1968); *Spevack* v. *Klein*, 385 U.S. 511, 514-16 (1967).

[35] *Cf. Kivitz* v. *SEC*, 475 F.2d 956, 962 (D.C. Cir. 1973).

[36] *In re Fisher*, 179 F.2d 361, 369 (7th Cir.), *cert. denied*, 340 U.S. 825 (1950) ("[T]he charges must be sustained by clear and convincing proof") (quoting *In re Donaghy*, 402 Ill. 120, 123, 83 N.E. 2d 560, 562 (1948)); *In re Adriaans*, 28 U.S. App. D.C. 515, 522 (1907). *See In re Ryder*, 263 F. Supp. 360, 361 (E.D. Va.), *aff'd*, 381 F.2d 713 (4th Cir. 1967) ("In proceedings of this kind the charges must be sustained by clear and convincing proof, the misconduct must be fraudulent, intentional and the result of improper motives.").

See also Charlton v. *FTC*, 543 F.2d 903, 906 (D.C. Cir. 1976). In *Charlton*, the court stated that, contrary to the

It is widely acknowledged that SEC disciplinary proceedings are "penal" or "quasi-criminal" in nature.[37] The SEC itself has described them as "closely analogous to proceedings for the collection of a statutory penalty." [38] Judge Friendly has emphasized that SEC disciplinary proceedings have the "quality of visiting serious consequences on past conduct" in characterizing their "penal" aspects.[39] Former SEC General Counsel, now Second Circuit Judge, Timbers labeled SEC disciplinary proceedings "quasi-punitive." [40] A leading commentator has singled out the frequent use of an agency's most severe sanctions as evidence that agency disciplinary proceedings have a "significant penal component." [41] Congress has character-

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FTC's concept, disciplinary proceedings are adversary proceedings of a quasi-criminal nature and disbarment is a punishment or penalty imposed on the lawyer. Although the court spoke of a preponderance standard, it also stated that the case "should be clear and free from doubt." As the court in *Collins* recognized, the *Charlton* court clearly "was referring to the type of clear and convincing evidence long required for discipline of attorneys." 562 F.2d at 825.

[37] Professor Jaffe has noted that the license revocation and suspension powers of administrative agencies are sanctions "far heavier than the ordinary fine" and serve "the functions of a criminal penalty." L. Jaffe, *Judicial Control of Administrative Action* 114 (1965).

[38] *Harold T. White*, 3 S.E.C. 466, 539-40 (1938).

[39] *Arthur Lipper Corp.* v. *SEC*, 547 F.2d 171, 180-81 n.6 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978).

[40] Timbers & Garfinkel, *Examination of the Commission's Adjudicatory Process: Some Suggestions*, 45 Va. L. Rev. 817, 824 (1959).

[41] L. Jaffe, *Judicial Control of Administrative Action* 267-68 (1965) ("Revocation, indeed, seems often to be used as a sanction not so much to control the respondent as to warn

ized the SEC's sanction of suspending or withdrawing registration as a "draconian remedy." [42] The statutory requirement that the SEC find "willful" violations before exercising its disciplinary powers parallels the criminal scienter standard and serves to underline the "penal" quality of the proceeding.[43]

There is no dispute that the sanction imposed by the SEC against Steadman in this case is a penalty. The court below explicitly so found.[44] The sanction would end Steadman's career and force him to sell his principal asset, his stock in SSC, at a substantial loss. It would permanently bar him from association with any registered investment company and suspend him from association with any broker-dealer for one year. As the court below recognized, "[E]xclusion from the industry is clearly a penalty" that is "indistinguishable in its effect on the respondent from disbarment from the practice of law." [45]

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others, and thus it has a significant 'penal' component, even though the courts may choose to mask its character by calling it a 'civil' remedy.").

[42] S. Rep. No. 75, 94th Cong., 1st Sess. 34 (1975). *See also Hammon Capital Management Corp.*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,449 at 82,891 (Jan. 25, 1980) (initial decision) (revocation of investment adviser's registration "far too draconic" for nonfraudulent violations).

[43] *Cf. Arthur Lipper Corp.* v. *SEC*, 547 F.2d 171, 180-81 nn.6, 7 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978).

[44] 603 F.2d at 1139.

[45] *Id. See Collins, supra*, 562 F.2d at 825 ("Disbarment or suspension is the equivalent to the penalty imposed on Collins by the SEC here.").

Under the SEC's rationale, as the SEC expressly stated in its decision in this case, *Steadman Security Corp.*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,243 at 88,319-19 n.88 (June 29, 1977), it would also be free to disbar an

The SEC has attempted to justify its preponderance standard by labeling these sanctions "remedial" rather than punitive.[46] The SEC's characterization misses a crucial point.[47] While the SEC may emphasize the remedial component of its disciplinary proceedings, its sanctions—that may deprive the respondent of the profession to which he has devoted a lifetime or impose greater financial sacrifices than the maximum fine for a criminal conviction under the federal securities laws[48]—are dis-

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attorney from practicing before it on the basis of a finding that the attorney had more likely than not committed a willful violation of the federal securities laws. The SEC would thus be in the anomalous position of needing less convincing evidence to deprive an attorney of his chosen professional specialty than would a state or federal judge sitting in a disbarment case.

[46] *See, e.g., Beck* v. *SEC*, 430 F.2d 673, 674 (6th Cir. 1970); *Berko* v. *SEC*, 316 F.2d 137, 141 (2d Cir. 1963); *Blaise D'Antoni & Assoc., Inc.* v. *SEC*, 289 F.2d 276, 277 (5th Cir.), *cert. denied*, 368 U.S. 899 (1961); *Pierce* v. *SEC*, 239 F.2d 160, 163 (9th Cir. 1956).

[47] As the Court noted in *Addington*, what the sanction is called "is less important than that we recognize that it can occur and that it can have a very significant impact on the individual." 441 U.S. at 426.

The SEC's interpretation in its administrative case law of the proper standard is not determinative. As this Court recently emphasized, the existence of a prior administrative practice does not relieve this Court of its responsibility to determine whether that practice is consistent with the SEC's statutory mandate. *SEC* v. *Sloan*, 436 U.S. 103, 117-19 (1978) (rejecting SEC's consistent interpretation, over a 34-year period, of Securities Exchange Act of 1934 provision).

[48] The loss of income resulting from permanent exclusion from the investment advisory business or even a one-year suspension from the brokerage business frequently exceeds the maximum $10,000 fine that can be imposed for the most

tinctly punitive. As the court in *Collins* recognized, "One would hardly say that removal of a criminal from society should be classed as 'remedial' because it protects ordinary citizens from the probable repetition of the crime." [49]

SEC disciplinary proceedings serve the purposes intended by Congress only to the extent that appropriate sanctions are properly and fairly applied. It is not "remedial" to bar from the securities business someone who is erroneously adjudicated guilty of willful fraud. Such a result wrongly deprives the public of a source of investment services,[50] curtails useful economic activity, and undermines industry confidence in regulatory bodies. The clear and convincing standard will thus serve the true purpose underlying the Congressional delegation of disciplinary authority, giving both the SEC and the securities community greater assurance that justice is done.

Greater assurance of justice is particularly important because of the nature of SEC proceedings. Unlike the federal courts in civil and criminal cases, the SEC is investigator, prosecutor, judge, and jury.[51] It does not accord respondents the degree of prehearing discovery avail-

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serious felony conviction under the federal securities statutes. *See, e.g.*, § 24 of the Securities Act of 1933, 15 U.S.C. § 77x (1976); § 32(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78ff (1976).

[49] 562 F.2d at 825.

[50] One of the principal goals of the Securities Exchange Act of 1934, as amended in 1975, is to promote competition in the securities industry. *See* S. Rep. No. 75, 94th Cong., 1st Sess. 8 (1975).

[51] *See* Schwartz & Wade, *Legal Control of Government* 270 (1972) ("One of the limitations of the administrative expert is his tendency to single-mindedness and excessive zeal. The judges can stand apart from the tensions of the immediate case and mitigate the enthusiasm of the expert by the community's sense of justice.").

able to litigants under the Federal Rules of Civil Procedure.[52] It allows into evidence a potpourri of "proofs" that would ordinarily be inadmissible in a civil or criminal trial pursuant to the Federal Rules of Evidence.[53] The SEC also has a consistent record of aggressive expansion of the scope of the federal securities laws through enforcement proceedings against individual respondents.[54]

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[52] For further discussion, *see* Mathews, *Litigation and Settlement of SEC Administrative Enforcement Proceedings*, 29 Cath. U.L. Rev. 215, 250-53 (1980). *Cf. Villani* v. *New York Stock Exchange*, 348 F. Supp. 1185 (S.D.N.Y. 1972), *modified*, 367 F. Supp. 1124 (S.D.N.Y.), *aff'd on other grounds sub nom. Sloan* v. *New York Stock Exchange*, 489 F.2d 1 (2d Cir. 1973).

[53] *See, e.g.*, Mathews, *Litigation and Settlement of SEC Administrative Enforcement Proceedings*, 29 Cath. U.L. Rev. 215, 258 (1980). Evidence need not even be "competent" to be admissible in SEC disciplinary proceedings. *Clinton Engines Corp.*, 41 S.E.C. 408, 411-12 (1963) (footnotes omitted). For examples of reversals by appellate courts of SEC disciplinary sanctions based upon unreliable evidence, *see, e.g., Kivitz* v. *SEC*, 475 F.2d 956 (D.C. Cir. 1973), *rev'g Murray* v. *Kivitz*, 44 S.E.C. 600 (1971); *Klopp* v. *SEC*, 427 F.2d 455 (6th Cir. 1970), *rev'g Paine, Webber, Jackson & Curtis (Klopp)*, 43 S.E.C. 1042 (1969); *Whitney* v. *SEC*, 604 F.2d 676 (D.C. Cir. 1979).

[54] The SEC both as a party and as *amicus* has, for example, consistently urged this Court to adopt expansive interpretations of the federal securities laws. *See, e.g., Aaron* v. *SEC*, 446 U.S. ——, 48 U.S.L.W. 4609 (U.S. June 2, 1980) (No. 79-66); *SEC* v. *Sloan*, 436 U.S. 103 (1978); *Chiarella* v. *United States*, 445 U.S. ——, 100 S. Ct. 1109 (1980); *Transamerica Mortgage Advisers, Inc.* v. *Lewis*, 444 U.S. 11 (1979); *Touche Ross & Co.* v. *Redington*, 442 U.S. 560 (1979); *International Brotherhood of Teamsters* v. *Daniel*, 439 U.S. 551 (1979); *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S. 1 (1977); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976); *Foremost-McKesson, Inc.* v. *Provident Sec. Co.*, 423 U.S. 232 (1976); *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837

It is precisely this type of vigorous enforcement in instances where "administrative procedures are less solicitous of the protection of the individual than are civil or criminal procedures" [55] that calls for the increased procedural protection of a greater standard of proof for administrative agencies "in situations where individuals stand to suffer serious liabilities." [56]

II. THE INTERESTS OF RESPONDENTS IN SEC PROCEEDINGS IN WHICH THEY ARE CHARGED WITH WILLFUL FRAUD REQUIRE THE USE OF THE "CLEAR AND CONVINCING" STANDARD OF PROOF.

In the overwhelming majority of SEC administrative disciplinary proceedings, the SEC alleges willful fraud under the various anti-fraud provisions of the federal securities statutes.[57] In such proceedings, the SEC must make a specific finding that a statutory violation is "willful" in order to impose a sanction.[58]

(1975); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975).

[55] Jaffe, *Administrative Law: Burden of Proof and Scope of Review*, 79 Harv. L. Rev. 914, 919-20 (1966).

[56] *Id.*

[57] "In the past decade (1970-1979), the Commission has instituted a total of 864 administrative proceedings in which the order commencing the proceeding alleged violations of one or more of the anti-fraud provisions involved in this case." SEC Brief in Support of Petition for Certiorari at 6 n.8 (April 1980), in the instant case.

[58] *See* Mathews, *Litigation and Settlement of SEC Administrative Enforcement Proceedings*, 29 Cath. U.L. Rev. 215, 238-39 (1980); 2 L. Loss, Securities Regulation 1307-12 (2d ed. 1961); 5 L. Loss, Securities Regulation 3366-77 (2d ed. Supp. 1969).

Willful fraud is a serious charge even when made in a civil or administrative context. An allegation of fraud is considered *per se* defamatory in most jurisdictions.[59] An adjudication of willful fraud stigmatizes the respondent,[60] destroys personal reputation, and frequently causes severe professional and business injury.[61] In the securities industry, SEC proceedings charging willful fraud frequently trigger civil lawsuits in which the SEC's findings may have collateral estoppel effect.[62] This Court has acknowledged the severe consequences of fraud charges, particularly against professionals, in recent securities cases.[63]

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[59] 50 Am. Jur. 2d *Libel and Slander* § 74 (1970); Restatement (Second) of Torts § 569, Comment g (1977). *See, e.g., Reliance Ins. Co.* v. *Barron's*, 442 F. Supp. 1341, 1345 (S.D. N.Y. 1977).

[60] *Whitney* v. *SEC*, 604 F.2d 676, 681 (D.C. Cir. 1979) (Sanctions depending on a finding of fraud "result in stigmatizing the defendant irrespective of the formal sentence meted out.").

[61] *Sea Island Broadcasting Corp.* v. *FCC*, No. 76-1735, slip. op. at 8-9 (D.C. Cir., Jan. 14, 1980).

[62] *See United States* v. *Utah Constr. & Mining Co.*, 384 U.S. 394 (1966); *Shore* v. *Parklane Hosiery Co.*, 565 F.2d 815, 819 n.1 (2d Cir. 1977), *aff'd*, 439 U.S. 322 (1979) ("[W]hen an administrative agency acts in a judicial capacity, collateral estoppel effect may be given to its findings of fact against the respondent rather than require relitigation in subsequent legal proceedings."); Pickholz and Brodsky, *An Assessment of Collateral Estoppel and SEC Enforcement Proceedings After Parklane Hosiery Co.* v. *Shore*, 28 Am. U.L. Rev. 37, 56-58 (1978); Note, *The Collateral Estoppel Effect of Administrative Agency Actions in Federal Civil Litigation*, 46 Geo. Wash. L. Rev. 65 (1977).

[63] *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214-16 n.33 (1976) and *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 747-48 (1975), *both quoting Ultramares Corp.* v. *Touche*, 255 N.Y. 170, 174 N.E. 441 (1931).

Because of the gravity of a willful fraud charge the courts have traditionally fashioned special safeguards in fraud cases. Under Rule 9(b) of the Federal Rules of Civil Procedure the circumstances constituting fraud must be "stated with particularity." A finding of fraud must usually be based on a finding of scienter.[64] Most important, many courts,[65] including this one,[66] have insisted that fraud be proved by clear and convincing evidence or "an even higher" standard.[67] As recently as last

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[64] *Aaron, supra,* at 4613-15; *Hochfelder, supra,* at 212-14.

[65] *See, e.g., Borowicz* v. *Chicago Mastic Co.,* 367 F.2d 751, 760 (7th Cir. 1966) ("Fraud is not to be presumed, but must be affirmatively established by clear and convincing proof of each and every essential element."); *Troeder* v. *Lorsch,* 150 F. 710, 714 (1st Cir. 1906) ("[W]hen a person is charged with all the elements which constitute a heinous crime, although it be only on a civil issue, it shocks the judicial mind to refuse to give him the benefit of the usual presumption of innocence unless the adverse proofs are so far satisfactory as to be convincing."). The court noted in *Collins*: "There are literally hundreds of cases decided by the United States Court of Appeals in which the standard applied in fraud situations has been 'clear and convincing evidence.'" 562 F.2d at 824 & n.27.

See C. McCormick, *Evidence* § 340 at 797 (2d ed. 1972); 9 J. Wigmore, *Evidence* § 2498 at 329 (3d ed. 1940). Dean Wigmore states that "some such phrase, as 'clear and convincing proof,' is commonly applied to measure the necessary persuasion for a charge of fraud," and collects the federal and state case law at 329 n.13.

[66] *See Lalone* v. *United States,* 164 U.S. 255, 257 (1896).

[67] *Woodby* v. *INS,* 385 U.S. 276, 285 n.18 (1966) (The clear and convincing "standard, or an even higher one, has traditionally been imposed in cases involving allegations of civil fraud"); *see Collins, supra,* 562 F.2d at 824-26; *Whitney* v. *SEC, supra,* 604 F.2d at 681 n.19 ("We intend the word 'fraud' not merely in its common law sense, but comprehending all violations of § 10(b) and rule 10b-5.").

term, the Court noted approvingly that many jurisdictions reduced "the risk to the defendant of having his reputation tarnished erroneously by increasing the plaintiff's burden of proof" to clear and convincing evidence in fraud cases.[68]

The use of the more exacting "clear and convincing" standard also reflects the belief of the courts that, since proof in cases involving fraud is often circumstantial and dependent on inference, the risk of an error by the trier of fact is particularly great. Basic fairness therefore requires use of the "clear and convincing" standard of proof to offset the enhanced risk of an erroneous result.[69] That securities fraud cases often turn on circumstantial proof is apparent not only from precedent[70] but also from the fact that such cases frequently involve findings with respect to the intentions of businessmen or

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[68] *Addington* v. *Texas*, 441 U.S. 418, 424 (1979).

[69] *See Lalone* v. *United States*, 164 U.S. 255, 257 (1896) ("A mere preponderance of evidence which at the same time is vague or ambiguous is not sufficient to warrant a finding of fraud, and will not sustain a judgment based on such finding."); *Collins, supra*, 562 F.2d at 823; *Whitney, supra*, 604 F.2d at 681 ("[D]espite the presence of some 'direct' testimony in this case, the state of the evidence is hardly unequivocal and we are reluctant to forgo the added assurance of correctness afforded by a heightened standard of proof.").

See also 12 Ga. L. Rev. 153, 154 n.9 (1977):

> The "clear and convincing evidence" standard first appeared in English equity cases involving the use of parol evidence. The courts were concerned about the quality of the evidence; hence, a more stringent standard of proof was adopted. *Townshend (The Marquis)* v. *Strangroom*, 31 Eng. Rep. 1076 (Ch. 1801); *Henkle* v. *Royal Exch. Assurance Co.*, 27 Eng. Rep. 1055 (Ch. 1749).

[70] *See, e.g., Collins, supra; Kivitz* v. *SEC*, 475 F.2d 956 (D.C. Cir. 1973); *Klopp* v. *SEC*, 427 F.2d 455 (6th Cir. 1970).

businesswomen forced to make economic choices under pressure with imperfect information.

The risk of error in SEC disciplinary proceedings in which willful fraud is alleged is heightened by the ambiguity and imprecision of important provisions of the federal securities laws.[71] Several times in the last few years this Court has rejected SEC interpretations of the anti-fraud and related provisions of the securities laws.[72] Several of these decisions suggest that the meaning of fraud may be particularly unclear in the securities context.[73] In such circumstances, the "clear and convincing" standard of proof affords an essential protection against an erroneous finding of willful fraud and the attendant stigma.

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[71] *See Collins, supra,* 562 F.2d at 822-23. *See* 12 Ga. L. Rev. 153, 157 n.24 (1977): "The [*Collins*] court noted that the practice of relying on inferential evidence is unobjectionable and is a result of the ambiguities and imprecisions of the securities laws."

[72] *See* cases cited at note 54, *supra.*

[73] The fiduciary nature of the standards of conduct imposed on investment advisers under the Investment Advisers Act, *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180 (1963), is not a reason for a lesser standard of proof under that statute. First, federal fiduciary responsibility law is, if anything, even more ambiguous than securities fraud law. Second, the clear and convincing standard has been required in an adjudication of willful fraud charges against a broadcasting licensee who is a statutory trustee with a special fiduciary duty to the public. *Sea Island Broadcasting Corp.* v. *FCC,* No. 76-1735 (D.C. Cir., Jan. 14, 1980). In any event, the Investment Advisers Act violation was but one of the violations upon which the SEC based its sanctions against Steadman. Among others, the SEC found willful violations of the anti-fraud provisions of § 17(a) of the Securities Act of 1933 and § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

III. ALTHOUGH THE COURT OF APPEALS CORRECTLY REQUIRED THE SEC TO JUSTIFY THE PARTICULAR SANCTIONS IT IMPOSES, THIS REQUIREMENT IS NOT A SUBSTITUTE FOR CLEAR AND CONVINCING EVIDENCE OF A WILLFUL VIOLATION.

In ordering the SEC to satisfy the "burden of justification" by articulating the reasons for choosing the precise sanction ultimately imposed on petitioner and in suggesting the range of factors the SEC might appropriately employ, the Fifth Circuit neither announced a new doctrine nor established additional procedural safeguards for respondents in SEC disciplinary proceedings. Rather the court merely engaged in traditional judicial review of final agency action by insisting on the first prerequisite of judicial review, an explanation of how the agency reached its decision.[74] Under the authority of the Administrative Procedure Act, 5 U.S.C. §§ 551(10), 551 (13), 702, 706 (1976), and the due process clause, numerous courts have reviewed and on occasion modified disciplinary sanctions imposed by the SEC.[75] The Court of Appeals neither purported to expand the law nor in fact did so.

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[74] *See Citizens to Preserve Overton Park* v. *Volpe*, 401 U.S. 402 (1971); *Nassar & Co.* v. *SEC*, 566 F.2d 790, 794 (D.C. Cir. 1977) (in remanding case, court emphasized need for specific factual findings supporting SEC's revocation order); *Beck* v. *SEC*, 413 F.2d 832, 834 (6th Cir. 1969), *after remand*, 430 F.2d 673, 675 (6th Cir. 1970) (court remanded case to SEC with instructions to disclose reasons for imposition of suspension order; after remand, court set aside four-month supervision order as a "gross abuse of the Commission's remedial authority").

[75] *E.g.*, *Arthur Lipper Corp.* v. *SEC*, 547 F.2d 171, 184-85 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978) (modifying severe broker-dealer revocation and bar order found to constitute an abuse of discretion); *Beck* v. *SEC*, 430 F.2d 673, 675 (6th Cir. 1970). *See* note 53, *supra*.

The Fifth Circuit decision should not be read to imply that the SEC's duty to explain its exercise of discretion in selecting particular sanctions is a substitute for "clear and convincing" proof that a willful fraud violation had occurred. Although the court did state that a high standard of proof to establish a willful violation is not "the only means to protect a respondent," [76] it nowhere suggested that it viewed different procedural protections as interchangeable or that its views about the proper standard of proof did not stand on their own merits. Indeed, the Court of Appeals did not even suggest that the SEC should consider whether its willful fraud finding was supported by clear and convincing evidence or only a mere preponderance of the evidence in choosing a sanction.

Nor should the long-standing and unexceptionable requirement that the SEC engage in a reasoned exercise of discretion in selecting sanctions substitute for clear and convincing evidence of a violation. First, the selection of a penalty proceeds from the premise that a willful violation has occurred. If that premise is erroneous—or if a respondent in an SEC disciplinary proceeding has to bear an unfair risk that it is erroneous—the unfairness of the entire disciplinary proceeding cannot be cured by the introduction of safeguards during the penalty phase of the proceedings.

A mere finding that a respondent has engaged in willful fraud has serious adverse consequences.[77] These consequences do not disappear with a subsequent administrative determination not to impose the most severe available sanction. Regardless of the choice of sanction, any unfairness in the underlying adjudication of willful fraud is ineradicable and will have direct, demonstrable, and deleterious effects upon the party unfairly tainted.

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[76] 603 F.2d at 1139.

[77] *See* text at notes 59-63, *supra*.

Branding the respondent as a willful fraud violator[78] may trigger private, and sometimes vexatious,[79] civil litigation in which the willful fraud finding may have a collateral estoppel effect.

Second, reliance solely on appropriate justification of the sanction will encourage the SEC to initiate proceedings on the basis of marginal evidence since the SEC will be able to justify a public censure even where the evidence establishes only that it is barely more likely than not that a willful violation occurred. Given the risks and expenses of litigation, adoption of the Fifth Circuit's approach is likely to enable the SEC to extract settlements from respondents who might otherwise not even be the targets of disciplinary proceedings.[80]

Third, the notion that a critically important procedural safeguard should depend upon the severity of the sanction actually imposed rather than the potential sanction at the outset of the proceeding is inconsistent with principles enunciated by this Court in other situations. For example, this Court has looked to the maximum authorized penalty in distinguishing between serious crimes and petty offenses for purposes of the Sixth Amendment right to jury trial.[81]

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[78] *See, e.g., Whitney, supra,* 604 F.2d at 684 (The record did not support the SEC's characterization of "petitioner as an ingenious schemer, deliberately spreading misimpressions and confusion.").

[79] *See Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 739-44 (1975).

[80] *See, e.g.,* H. Kripke, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose* 47-51 (1979); *Parklane Hosiery Co.* v. *Shore,* 439 U.S. 322, 355-56 (1979) (Rehnquist, J., dissenting).

[81] *See Codispotti* v. *Pennsylvania,* 418 U.S. 506, 511 (1974); *Baldwin* v. *New York,* 399 U.S. 66, 68 (1970); *Frank* v. *United States,* 395 U.S. 147, 149 (1969) ("[T]he severity of

Finally, the Fifth Circuit was quite careful to point out the modest degree of protection that is afforded by judicial review of the SEC's choice of sanction.[82] In light of such narrow review, the requirement that the SEC justify its choice of sanction is no substitute for the protection afforded by insisting that the trier of fact find clear and convincing evidence of willful fraud.

CONCLUSION

Respondents in SEC administrative disciplinary proceedings have important personal and professional "interests at stake . . . more substantial than mere loss of money." *Addington* v. *Texas*, 441 U.S. 418, 424 (1979). As this Court pointed out in *Addington*, "[T]he ultimate truth as to how the standards of proof affect decision-making may well be unknowable. . . . Nonetheless, even if the particular standard-of-proof catchwords do not always make a great difference in a particular case, adopting a 'standard of proof is more than an empty semantic exercise.' " [83]

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the penalty authorized, not the penalty actually imposed, is the relevant criterion."); *Duncan* v. *Louisiana*, 391 U.S. 145, 159 (1968) ("[T]he penalty authorized for a particular crime is of major relevance in determining whether it is serious or not and may in itself, if severe enough, subject the trial to the mandates of the Sixth Amendment.").

[82] 603 F.2d at 1139-40. *See Butz* v. *Glover Livestock Commission Co.*, 411 U.S. 182, 185 (1973) (citing *American Power Co.* v. *SEC*, 329 U.S. 90, 112 (1946)).

[83] 441 U.S. at 424-25 (citing *Tippett* v. *Maryland*, 436 F.2d 1153, 1166 (4th Cir. 1971) (Sobeloff, J., concurring in part and dissenting in part), *cert. dismissed sub nom. Murel* v. *Baltimore City Criminal Court*, 407 U.S. 355 (1972)). *See also In re Winship*, 397 U.S. 358, 369-70 (1970) (Harlan, J., concurring). *Cf.* Underwood, *The Thumb on the Scales of Justice: Burdens of Persuasion in Criminal Cases*, 86 Yale L. J. 1299, 1311 (1977).

Amicus SIA respectfully suggests that clear and convincing evidence of willful fraud is essential in SEC disciplinary proceedings to balance the risks of erroneous decisions that are detrimental to society at large, as well as to industry professionals who make up the pool of prospective respondents in SEC administrative disciplinary proceedings. The mere preponderance standard does not satisfy society's demands of procedural fairness to individuals whose personal and professional reputations and livelihoods are at stake.

For the reasons set forth above, the decision of the Court of Appeals should be reversed insofar as it held that the SEC may find a willful violation of the antifraud provisions of the federal securities laws based on a mere preponderence of the evidence, and affirmed insofar as it required the SEC to justify with particularity the sanction it chooses to impose.

Respectfully submitted,

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July 15, 1980